

Case No. A059403

Save Affordable Housing, et al., City of Berkeley, etc.

vs.

City of Berkeley Rent Stabilization Board

Appeal from A Final Judgment of Alameda County Superior Court

The Honorable John Sutter, Judge

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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION FIVE

CITY OF BERKELEY RENT STABILIZATION BOARD
and BERKELEY PROPERTY OWNERS' ASSOCIATION,
Appellants-Cross-Appellees

NO. A059403

v.

CITY OF BERKELEY,
Appellee-Cross-Appellant and

SAVE AFFORDABLE HOUSING,
Appellee

BERKELEY PROPERTY OWNERS' ASSOCIATION
Appellant-Intervenor-Cross-Respondent

DAGMAR SEARLE, et al.
Intervenors

OPENING BRIEF OF APPELLANT

BERKELEY RENT STABILIZATION BOARD

APPEAL FROM A FINAL JUDGMENT OF ALAMEDA COUNTY SUPERIOR COURT

HONORABLE JOHN SUTTER, JOSEPH CARSON, RICHARD BARTALINI
JOANNE PARRILLI, and DEMETRIOS AGRETELIS, JUDGES

SUPERIOR COURT NO. 683721-5 OH
and NO. 683726-0 (CONSOLIDATED)

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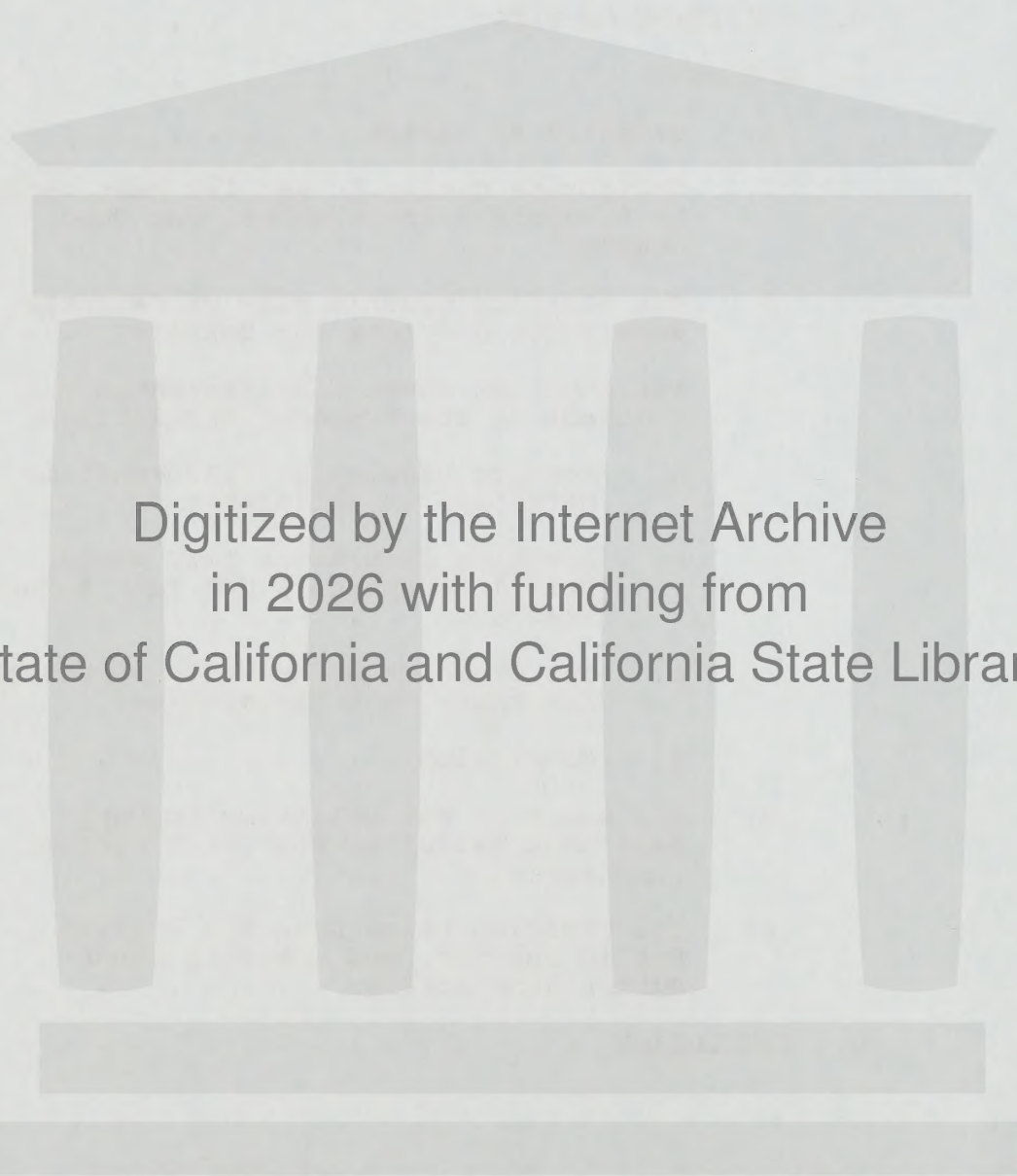
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1 A. STATEMENT OF THE CASE

2 The City of Berkeley Rent Stabilization Board (the
3 "Board") appeals two issues decided by a September 17, 1992
4 final judgment of the Alameda County Superior Court (Hon. John
5 Sutter).

6 The Board was respondent below in two actions, which
7 were consolidated at the times relevant to this appeal. Each
8 action combined a petition for writ of mandate and a complaint
9 for declaratory and injunctive relief. Respondents here City of
10 Berkeley and Save Affordable Housing each brought one action.
11 The complaints below raised a number of claims; relief was
12 denied on nearly all. The City of Berkeley has cross-appealed
13 several of these denied claims.

14 In the Superior Court, five judges heard one or more
15 aspects of the two cases, the first of which was filed on
16 July 22, 1991 (Joint Appendix--hereinafter "JA"--at 1).
17 However, the Board's appeal concerns only a portion of Judge
18 Sutter's final judgment. Judge Richard Bartalini previously
19 heard argument on the issue in question in the context of a
20 motion for preliminary injunction, but his order denying
21 preliminary relief (JA at 1574) does not state his view on the
22 merits.

23 The facts of the case most relevant to the Board's
24 appeal are set forth in the Statement of Facts below.

25 ///

26 ///

27 ///

28 ///

1 B. STATEMENT OF FACTS

2 The regulations at issue on this appeal seek to provide
3 "fair return" rent increases under the Berkeley Rent
4 Stabilization Ordinance. Berkeley has regulated rents since
5 1978 (JA at 980-91). Since 1980, an initiative now codified as
6 Chapter 13.76 of the Berkeley Municipal Code (the "Rent Law" -
7 JA at 457) has controlled Berkeley rents.

8 From the beginning, the Rent Law was designed to allow
9 landlords to increase rents one dollar to cover each one dollar
10 increase in operating costs (Rent Law §11(b)(1), JA at 461;
11 former Regulation 1264, providing for maintenance of net
12 operating income, originally adopted in 1981, Exhibit B to the
13 Board's Request for Judicial Notice filed herewith). The Rent
14 Law also recognizes that additional rent increases, beyond those
15 to cover higher costs, may be needed to provide a "fair return
16 on investment" (Rent Law §§12(c), 12(i), JA at 462). However,
17 the law does not say how to increase rents--in any amount--to
18 provide a fair return.

19 The Board wrestled for more than a decade with the
20 question of a "fair return" on investment. The question took
21 the form of whether, and how, to allow income, net of operating
22 costs, to increase. The Board early acknowledged an obligation
23 to allow incomes to increase. See, e.g., JA at 2103, noting
24 presentation of the issue in 1982 and 1983; Fisher v. City of
25 Berkeley (1984) 37 Cal.3d 644, 682, n.37 (noting the Board's
26 formal concession in 1983 that it was authorized to increase
27 rents to protect landlords' incomes against inflation).

28 However, the issue proved thorny, politically, conceptually and

1 administratively (see Baar, Guidelines For Drafting Rent Control
2 Laws: Lessons of a Decade (1983) 35 Rutgers L. Rev 721, a 122-
3 page analysis by the Board's then-principal consultant).

4 In 1986 the Board still had not enacted regulations
5 which allowed incomes to increase; the Alameda County Superior
6 Court ordered it to do so (JA at 2034-2035, n. 2). The Board
7 appealed (*id.*). Ultimately, in 1987 the Board adopted
8 regulations, under its authority to provide a "fair return on
9 investment". It then dismissed its pending appeal.

10 The 1987 regulations provided, among other things, for
11 increasing individual owners' net operating income ("NOI") at
12 forty percent of the rate of inflation since the beginning of
13 rent control (see JA at 2206). Such increases were available
14 only in cases where individual landlords filed petitions (*id.*).
15 They were available to all owners, whether they had purchased
16 their Berkeley property before or after rent control began.

17 Those 1987 regulations were in turn challenged, and
18 ultimately invalidated by this court's unpublished opinion dated
19 July 18, 1990 in Searle v. Berkeley Rent Stabilization Board,
20 No. A044761 (JA at 2205 et seq.). Among the regulation's
21 defects which the Searle opinion identified was the lack of a
22 basis to index operating income for only 40% of inflation.

23 Pursuant to a peremptory writ of mandate issued February
24 7, 1991, following the Searle remittitur, the Board conducted
25 extensive proceedings. It ultimately adopted five regulations,
26 four of which were challenged in the Superior Court action
27 leading to this appeal--Regulations 1100, 1113, 1262(C)(3) and
28 1280. (Regulation 1264, also amended pursuant to the Searle

1 writ, is not challenged here.^{1/}) The Board adopted Regulation
2 1262(C)(3) on April 15, 1991 (Administrative Record--
3 hereinafter "AR" -- at 170, 172); Regulation 1280 on May 23,
4 1991 (AR at 940-942, 962); Regulation 1100 on September 16, 1991
5 (AR at 403B^{2/}); and Regulation 1113 on September 26, 1991 (AR at
6 505B). Regulations 1262(C)(3) and 1280 have since been amended;
7 current copies of all these regulations will be lodged with the
8 Court prior to argument.

9 The Board's appeal concerns a modification which the
10 Superior Court imposed on three of the regulations (Regulations
11 1113, 1262(C)(3) and 1280), limiting their application where
12 property has changed hands since rent control began. This
13 modification of Regulation 1113 is the first subject of the
14 Board's appeal.

15 Conceptually, Regulation 1113 provides that rents should
16 be allowed to increase to fully adjust operating income for
17 inflation, as well as to cover operating cost increases on a
18 dollar-for-dollar basis. It covers the period 1979 through
19

20 ^{1/}Like Regulation 1113, Regulation 1264 provides for increasing
21 net operating income at the inflation rate; unlike Regulation
22 1113 it requires an individual hearing for each landlord who
23 seeks such an increase. It allows actual base year net
24 operating income for the specific affected property to increase
at the inflation rate, even if larger rent increases result than
under the general net operating income assumptions which
underlie Regulation 1113. The text of Regulation 1264 as of May
1992 is at JA 2402.

25 ^{2/}The record of Board proceedings concerning these regulations,
26 or "administrative" record, was prepared in separate
installments, one concerning Regulations 1012, 1262 and 1280 as
27 adopted in spring 1991 and the other concerning the "Searle"
regulatory changes adopted in the fall. To avoid confusion
28 resulting from duplicate page numbers, with all parties' consent
the letter "B" has been added to page designations for part of
the record.

1 1990, for which the Board had not previously allowed inflation
2 increases in NOI. It adjusts rents beginning at the end of 1991
3 for inflation during the 1979 to 1990 period, but does not
4 affect pre-1991 rents. The regulation does not require
5 individual landlords to petition the Board. To avoid the
6 individual petition process, the regulation applies a formula,
7 which is described in the next two paragraphs.

8 Regulation 1113 uses "net operating income" at the
9 outset of rent control as a measuring stick.^{3/} To arrive at net
10 operating income at the outset of rent control, the Board used
11 the earliest individual unit rents for which it has reliable
12 records, which are from May 1980 (JA at 998-999, 1026-1027).
13 Using a typical figure for the ratio of net operating income to
14 rent at the outset of rent control (that operating costs were
15 40% of total rent and net operating income was 60% of total rent
16 -- AR at 385B), the regulation assumes that for each property
17 base net operating income equaled 60% of total 1980 rents for
18 that property.

19 Regulation 1113's goal is to allow base net operating
20 income to increase at the rate of the Consumer Price Index
21 (except that the shelter, or "housing" component is removed from
22 the CPI, which lowers the rate of CPI increase (AR at 262B-
23 263B)). The (modified) CPI increased approximately 75% during
24 the period which Regulation 1113 covers (AR at 385aB), so the
25 regulation allows base net operating income to increase by 75%.

27 ^{3/} Net operating income, or "NOI", is defined by Board
28 Regulation 1263 as gross income, less property taxes, reasonable
maintenance and operating expenses and the amortized cost of
capital improvements.

1 As noted above, base net operating income is estimated to be 60%
2 of 1980 base rent. The regulation therefore allows a rent
3 increase in the amount of 75% of 60% of base rent. That is
4 (since 75% of 60% equal 45%), ultimately each property's current
5 rents may increase by an amount equal to 45% of the 1980 base
6 rents.

7 The Superior Court generally upheld Regulation 1113
8 against petitioners' challenges below. However, it found that
9 increasing pre-rent control income at the CPI rate was unlawful
10 for properties which had been sold during rent control. For
11 those properties, the Court determined that the lawful course
12 under the Rent Law was to allow net operating income to increase
13 only to reflect inflation since the time of transfer. In
14 essence, the court reasoned: 1) the Rent Law allows only those
15 rent increases necessary to give a "fair return on investment";
16 2) since rent control began, owners must have invested based on
17 rents at the time they purchased, believing that rent control
18 would limit future increases; and 3) Regulation 1113's formula
19 gives more than a fair return on their presumably lower post-
20 rent control investments (JA at 2032-2033). In the Board's
21 public hearings, this issue came up just before the regulation
22 was adopted, in a brief statement on September 10, 1991 (AR at
23 793B), with brief responses on September 26, 1991 (AR at 621-
24 622, 631-632).

25 Regulations 1262(C)(3) and 1280, the second and last
26 subject of the Board's appeal, deal with rents which were
27 extraordinarily low at the outset of rent control. (Regulation
28 1113 takes base rents as it finds them.)

1 Regulation 1262(C)(3) allows base year rents to be
2 increased (for the purposes of calculating the rent now allowed)
3 if, following a hearing concerning the specific property, the
4 Board finds the base year rent was "below prevailing market
5 rents for comparable units" Regulation 1280 provides by
6 general rule specific minimum adjustment amounts for base rents
7 which were initially, and remain, below specified minimums. The
8 Superior Court found that these regulations were lawful under
9 the Rent Law (which petitioners below had disputed), but that
10 the regulations could not lawfully be applied to allow any rent
11 increases for properties which had been sold under rent control.
12 This last point was not raised before the Rent Board when the
13 regulations were adopted or in petitioners' papers in the court
14 below.

15 C. ARGUMENT

16 There is no "right" answer to the question: What return
17 is fair under rent control? No law prescribes--and no court is
18 required to identify--the "right" formula to determine "fair
19 return on investment" under the Berkeley Rent Law.

20 Neither the Rent Law itself nor any other existing legal
21 authority obligates Berkeley to partially abandon the fair
22 return system it has used since 1987, or the net operating
23 income analysis it has used since 1981 (under the former version
24 of Regulation 1264).

25 Since 1987, Berkeley has measured fair return on
26 investment by increasing pre-rent control net operating income
27 for post rent-control inflation. (Before Regulation 1113 was
28 adopted in September 1991, the Board used the smaller percentage

1 adjustment and the individual petition procedure described in
2 Searle.) No law requires the Board to substitute now, for
3 properties sold since 1979, regulation based implicitly on a
4 particular owner's post-rent control investment decision. The
5 Board's decision not to make this change was neither arbitrary
6 nor capricious.

7 In essence, the judgment below inappropriately
8 prescribes an alternative policy, which the Superior Court
9 believed to be fairer. Not only is fairness in this context a
10 legislative, rather than judicial, issue, but the Superior
11 Court's proposal presents several serious problems. The record
12 before the Board--the relevant record here and in the lower
13 court--does not support the lower court's mandate to revise the
14 regulation.

15 In any event, the lower court's proposed solution should
16 be tested by public hearings and the legislative process. This
17 has not occurred, and the judgment below allows at best limited
18 scope for that consideration.

19 This brief first identifies the standard for review of
20 the Board's regulations. Next, it shows that Berkeley's current
21 treatment of fair return on investment is consistent with that
22 in other cities, and with case law concerning fair return
23 generally. Then it turns to the practical problems raised by
24 more literal approaches to "fair return on investment", and by
25 the Superior Court's approach in particular. It concludes that,
26 while the Superior Court must have believed that its solution
27 was fairer than the one which the Rent Board devised, that
28

1 belief may well be incorrect, and in any event should not
2 control the outcome of this action.

3 1. Standard of Review

4 Applicable precedent establishes that the Board's
5 regulations should stand, unless the Board has adopted them
6 arbitrarily or capriciously.^{4/} Under any applicable standard of
7 review, this Court reviews de novo the Superior Court's decision
8 to overturn parts of the regulations.^{5/}

9 Courts defer to specialized administrative agencies like
10 the Board when reviewing regulations like those at issue here.
11 First, they defer to the agency in determining whether the
12 regulation is within the bounds of the agency's enabling
13 statute. Ralphs Grocery Co. v. Reimel (1968) 69 Cal.2d 172, 174-
14 175. Also, where adoption of regulations involves agency
15 consideration of factual issues, judicial review is limited to
16 an examination of the proceedings and evidence before the
17 agency. Pitts v. Perluss (1962) 58 Cal.2d 824, 832; Shappell
18 Industries v. Governing Board (1991) 1 Cal.App.4th 218, 233-
19 234; Langsam v. City of Sausalito (1987) 190 Cal.App.3d 871,
20 879; Court House Plaza Co. v. City of Palo Alto (1981) 117
21 Cal.App.3d 871, 881. See also Lewin v. St. Joseph Hospital

22
23 ^{4/} The Superior Court in this case reached its conclusion
24 without specifying any standard of review (JA at 2039, tentative
decision at p. 21).

25 ^{5/} A Court of Appeal considers de novo questions of law, to the
26 extent those are addressed here. Lockard v. City of Los Angeles
27 (1949) 33 Cal.2d 453, 461-462; Shoban v Board of Trustees (1969)
28 276 Cal.App.2d 534, 541. Likewise, where a challenged
legislative action involves fact-finding, the action is to be
upheld if supported by substantial evidence. Appellate courts
review de novo the question of whether substantial evidence
exists. Bixby v. Pierno (1971) 4 Cal.3d 130, 149.

1 (1978) 82 Cal.App.3d 368, 383-87 & n.13 (review of rule or
2 policy decision by administrative agency must be based solely
3 upon the evidence considered by the administrative agency).^{6/}

4 In determining whether a quasi-legislative act was
5 arbitrary, capricious or unsupported by the evidence contained
6 in the record, the reviewing court "does not inquire whether, if
7 it had power to draft the regulation, it would have adopted some
8 method or formula other than that promulgated" by the agency.
9 Pitts v. Perluss, 58 Cal.2d at 834-35. "If reasonable minds may
10 well be divided as to the wisdom of an administrative board's
11 action, its action is conclusive." Id. "Or, stated another
12 way, if there appears to be some reasonable basis for the
13 [agency's decision], a court will not substitute its judgment
14 for that of the administrative body." Pitts v. Perluss, 58
15 Cal.2d at 834-35 & n.2 (emphasis in original).

16 Principles of deference apply with special force to rent
17 control, with its complex balance of conflicting economic
18 factors.

19 Our courts have ruled time and again that rent control
20 agencies are not obliged to fix rents by application of any
21 particular method or formula. [Citations omitted.] As in other
22 methods of rent calculations, a court "may compel [an] agency to
23 act, but it may not substitute its discretion for the discretion
24 properly vested in the administrative agency . . . 'Courts
25 should let administrative boards and officers work out their
26 problems with as little judicial interference as
27 possible . . .'" [Citations omitted.]

28 Cole v. Oakland Residential Rent Arbitration Bd. (1992) 3
Cal.App.4th 693.

^{6/}A more liberal rule applies in California Environmental
Quality Act ("CEQA") proceedings, under Public Resources Code
§§21168 and 21168.5. See Shappell Industries v. Governing Board
(1991) 1 Cal.App.4th at 233.

1 Under these standards, Regulations 1113, 1262(C)(3) and
2 1280 should be upheld.

3 2. California Cities Do Not Tie Rent Control to
4 Landlords' Investments, for Good Reason.

5 Other California cities, like Berkeley, rely on net
6 operating income as a measuring stick for rents of controlled
7 properties. In contrast, the Board knows of no California city
8 which follows the method prescribed by the lower court here.

9 California cities which control apartment rents
10 generally test for "fair" return by adjusting base year net
11 operating income for inflation, much as Berkeley does. These
12 cities have made a threshold choice between analyzing landlords'
13 particular investments in particular properties (as would result
14 from the Superior Court decision here), or establishing
15 generally applicable rent ceilings based on net operating income
16 rules. All of the six California cities (excluding Berkeley)
17 which as of mid-1991 had a discernible fair return standard for
18 apartments relied on base year net operating income, adjusted
19 for inflation. AR at 453B. That is what the Berkeley
20 regulations in issue here do. No city, so far as the record
21 reveals, adjusts base year NOI only for inflation after the
22 property changed hands.

23 The Rent Law's references to "fair return on investment"
24 do not demand a different result in Berkeley. "Fair return on
25 investment" does not have a narrow meaning. A net operating
26 income based standard is a reasonable means of implementing the

1 concept of "fair return on investment". Other cities, like
2 Berkeley, rely on net operating income although their enabling
3 ordinances refer to "fair return on investment" or "just and
4 reasonable return". See Vega v. City of West Hollywood (1990)
5 223 Cal.App.3d 1342 (NOI-based rent control under an ordinance
6 calling for a "just and reasonable return"); Baker v. City of
7 Santa Monica (1986) 181 Cal.App.3d 972, 988 (describing an NOI
8 standard as "essentially a return on investment standard");
9 Cotati Alliance for Better Housing v. City of Cotati (1983) 148
10 Cal.App.3d 280, 284 n.4, AR at 108B-109B (NOI-based rent control
11 under ordinance calling for "fair return on investment").

12 No reported California authority concerning rent control
13 requires a particular fair return standard. To the contrary,
14 "rent control agencies are not obliged by either the state or
15 federal Constitution to fix rents by application of any
16 particular method or formula." Fisher v. City of Berkeley
17 (1984) 37 Cal.3d 644, 680. As long ago as the Fisher decision,
18 the Supreme Court listed a "smorgasbord" of possible fair return
19 standards taking up most of a page in the published opinion.
20 Id.

21 Rent control cities' reluctance to consider landlords'
22 investments is well-founded in practical considerations.
23 California's leading consultant to tenant-oriented rent control
24 jurisdictions noted the following difficulties with reading
25 "fair return on investment" literally:

26 a. "Fair return on investment in a price regulation
27 context is circular because it is the role of the investor to
28 regulate investment according to the returns that may be

1 permitted, rather than the role of price regulation to reflect
2 investment expectations." In other words, if higher investments
3 triggered higher rents, "speculation" would be rewarded; rents
4 would then be controlled only to the extent particular owners
5 were able--and willing--to acquire properties at low prices.

6 b. "Current rates of return normally vary among
7 properties according to expectations about appreciation and
8 other tax benefits. Therefore, it is not reasonable to
9 designate a particular rate of return as fair for all
10 properties."

11 c. Discrimination is inherent in return on investment
12 standards, because different mortgage rates and principal
13 amounts lead to differences in allowable rents or returns.

14 d. It is impossible to develop a reasonable across-
15 the-board formula for return on investment, but without a
16 formula, individual fair return decisions may be reached "in a
17 highly subjective manner."

18 Baar, California Rent Controls: Rent Increase Standards and Fair
19 Return, VIII CEB Real Property L.Rptr. (July 1985) 97, 103-104.

20 The Board allows rent increases in many contexts without
21 determining the landlord's investment,^{1/} and without legal
22 challenge or controversy. Petitioners were prepared to allow
23 such increases as well. Below, they principally sought to
24 reduce the rate of net operating income-based increases. If
25 successful, they would have allowed similar increases for all

26
27 ^{1/}For example, Regulations 1262(C)(2) (base rent adjustments),
28 1267 (capital improvements), 1269 (changes in space or
services), and 1270 (change in number of tenants) allow such
increases.

1 landlords, irrespective of date of acquisition (see, e.g. JA at
2 400, City's brief at 9:5-7). Berkeley voters rejected two
3 initiatives, in June 1992 and November 1992, both designed to
4 reduce the rent increases allowed by the challenged regulations
5 (see Exhibits C and D to the Board's Request for Judicial
6 Notice). Neither initiative turned on date of acquisition.

7 In short, for reasons long recognized in and outside of
8 Berkeley, no law requires rent control agencies to determine
9 rents based on the particular facts of specific landlords'
10 varying investments. Berkeley's current standard based on pre-
11 rent control NOI provides a fair return on investment, within
12 the meaning of the Rent Law.

13 3. The Superior Court's View of Fairness Should
14 Not Displace the Board's.

15 For the reasons given in the preceding section of this
16 brief, "return on investment" lawfully can be, and commonly is,
17 regulated based on pre-rent control net operating income. The
18 Superior Court could have accepted this principle about "return
19 on investment" in general, but believed that allowing the same
20 NOI-based rent increases to post-rent control purchasers in
21 Berkeley in particular is not "fair". However, fairness here is
22 for Board members elected by Berkeley voters to judge, so long
23 as those Board members are not arbitrary or capricious.

24 Judicial modification of the Board's conclusion is
25 particularly troubling here because the lower court relied on a
26 critical fact not established by the record: that once rent
27 control started, purchasers bought Berkeley rental property
28

1 based solely on then-current rents (see JA at 2032-2033,
2 Tentative Decision pp. 14-15).

3 It seems more likely, as discussed below, that this was
4 true only to varying degrees at various times, and varied among
5 individual purchasers as well. The Board record contains
6 principally information which supports the conclusion that
7 purchasers did count on future rent increases (AR at 622B,
8 631B). The Board's consultants found the post-rent control
9 purchaser distinction in no other program (AR at 99B-111B). No
10 one advocated it at a public hearing until the regulations were
11 on the eve of adoption (and the return deadline for the Searle
12 writ one week away), and then only by a bare proposal of the
13 idea, without evidence (AR at 793B).

14 If the Superior Court is upheld, the Board will be
15 foreclosed from weighing the facts on this issue, and balancing
16 any possibility of greater "fairness" against the potential
17 drawbacks of segregating post-rent control purchasers (some of
18 which are outlined below). That result cannot be squared with
19 the well-established principle in the cases cited in section 1
20 above, that the courts defer to policy-making bodies.

21 Regulation 1113 as adopted carries out the Board's
22 conclusion that the fairest basis for Berkeley rents is rents
23 before control began (modified where pre-control amounts were
24 markedly depressed), consistently adjusted. This approach
25 roughly equalizes rents for similar apartments, simplifies
26 administration (reducing costs and delays for all parties) and
27 entails neither untested assumptions about, nor protracted
28

1 adjudication of, the investment expectations of landlords
2 individually or as a group.

3 4. The Superior Court Underestimated the Problems of
4 Its Proposed Regulations.

5 The Superior Court's proposed gloss on Regulation 1113
6 is likely to make rent control more complicated, slower and,
7 from the point of view of most future tenants and owners, to
8 perpetuate arbitrary differences in rents.

9 As noted above, the court below determined that Berkeley
10 must depart from the net operating income standard as used
11 elsewhere, and as used in Berkeley since at least 1987, for
12 properties which have been sold since rent control began. For
13 those properties, rents would still be tested by their ability
14 to increase base year net operating income, but no increase
15 would be allowed for inflation during rent control but before
16 the owner acquired the property. This rests on an express
17 conclusion about investment (as to which no evidence is cited
18 from the Board record, as noted above): that the prices of
19 Berkeley properties throughout the 1980s depended solely on
20 rents at the time of purchase.

21 a. Revised Regulation 1113 Would Be Difficult to
22 Administer.

23 A regulation which did no more than tailor the inflation
24 adjustment to the year of purchase would itself be more
25 complicated and unwieldy than Regulation 1113. It would require
26 case-by-case determination to determine both if a property
27 transfer had occurred which should affect rents, and when the
28

1 transfer occurred. It would require year-by-year or perhaps
2 month-by-month calculations for the inflation formula.

3 However, revised Regulation 1113 would have to do more.
4 This would lead to a more important, less tractable problem.
5 Such a regulation would have to create a regulatory process for
6 allowing additional rent increases to owners whose post-rent-
7 control investment was based on getting future rent increases
8 for inflation, as the Superior Court acknowledged (JA at 2030-
9 2031, 2059-2061, 2140-2142). For the properties it affects,
10 this process presents the same problems as a system which tests
11 each owner's investment and return, property-by-property (see
12 section 2 above). Depending on: (i) the number of properties
13 sold since rent control began, (ii) typical expectations from
14 time to time during more than ten years, of future rent
15 increases and (iii) the difficulty of adjudicating what owners'
16 expectations were, the resulting administrative difficulties
17 would range from serious at least to crippling at worst.^{8/}

18 In the absence of a record, the most plausible guess is
19 that purchasers of Berkeley rental property since 1979 in fact
20 have ranged from "pessimists" who doubted rents would ever be
21 adjusted for inflation, to "optimists" who believed that rent
22 control was sure to be abolished. Beginning in 1987, even the
23 pessimists could have expected indexing of net operating income
24 at 40% of the inflation rate under the Board's then-enacted
25 regulations. The decision below seems to instruct the Board to
26 presume that the 1987 regulations did not affect landlords'

27
28 ^{8/}Preliminary Board research after the Tentative Decision below
found changes of record ownership in two-thirds of Berkeley's
rent-controlled properties (JA at 2059-2060).

1 pessimism (JA at 2140-2141, expressing doubt as to how the
2 later, post-Searle 1991 regulations affected property owners).

3 The Superior Court would allow the Board to show that
4 acquiring landlords as a class were in fact optimists to some
5 degree. However, the court significantly constrained the Board
6 in this respect, by requiring evidence (underlining in original;
7 JA at 2140) sufficient to isolate the effects of events giving
8 rise to optimism (like the Fisher decision and adoption of
9 regulations) from the other factors affecting real estate
10 prices. Evidence in the sense the court below suggests may be
11 impossible. Among the difficult questions which would have to
12 be answered are: 1) How can shifts in capitalization ratios
13 resulting from shifts in the rent control climate be separated
14 from those resulting simultaneously from other factors, such as
15 changes in economic activity and interest rates; and 2) How can
16 a base capitalization ratio for pure "pessimism" be established,
17 given that some additional "fair return" increase has been
18 promised (with varying degrees of conviction) for ten years?

19 If the Board must make all optimists prove their
20 optimism, one at a time, that would require hundreds or
21 thousands of protracted and inherently subjective individual
22 adjudications. How can optimism about future rent increases be
23 separated in the case of particular properties from other
24 considerations that affected individual purchasers? Petitioners
25 suggested at argument below that a statement under penalty of
26 perjury be sufficient proof in such a hearing (Reporter's
27 Transcript of Proceedings, May 26, 1992, at 80:20-25); this
28

1 implausible suggestion underscores the difficulty of such
2 hearings.

3 Such a policy would produce substantive results at least
4 as undesirable as its technical difficulties. Such individual
5 adjudications would reward owners who risked higher purchase
6 prices (pejoratively, "speculators"), and by contrast penalize
7 other purchasers. Applied with strict logic, this policy would
8 permit owners to receive rent increases larger than Regulation
9 1113 provides, if only they paid enough for their property.

10 b. Revising Regulation 1113 Could Entail Inventing a
11 New Fair Return Standard.

12 In addition, differentiating post-rent control buyers
13 could require the Board to devise a new test for fair return in
14 individual cases, or, alternatively, by following its existing
15 Regulation 1264, to create tension with the lower court
16 decision.

17 Regulation 1113 sets out a general formula for all
18 properties. Board Regulation 1264 allows--as the U.S.
19 Constitution may well require--owners to petition individually
20 to insure a fair return on their particular property. The test
21 Berkeley now uses under Regulation 1264 is actual pre-rent
22 control base year net operating income for the property in
23 question, with a full inflation adjustment. This standard can
24 be objectively applied and appears to allow all owners a
25 constitutionally defensible return.

26 No similar standard is possible based on net operating
27 income in the year a particular owner acquired property, because
28 all parties have acknowledged that some owners may not receive a

1 fair return from that approach. No satisfactory alternative is
2 on the horizon; none was identified--despite extensive review--
3 by the consultants the Board retained to help it comply with the
4 requirement of the Searle decision that it establish a standard
5 for individual fair return decisions (AR at 443B et seq.; see
6 recommendation at AR 501B). The decision below explicitly
7 leaves Regulation 1264 unaffected (JA at 2062-2063, 2143).

8 The result is to make available rent increases similar
9 in amount to those under Regulation 1113, for owners willing to
10 pay the price of pursuing an adjudicatory hearing for an
11 individual property under Regulation 1264. If the lower court
12 decision stands, the Board could either reopen the broader fair
13 return issue, or Regulation 1264 would make available through
14 property-by-property petitions increases likely to approximate
15 those which the Superior Court disallowed.

16 c. The Decision Below Would Perpetuate Arbitrary Rent
17 Disparities.

18 The decision below would also prevent Berkeley,
19 apparently in perpetuity, from moving to equalize rents for
20 similar units. Units which changed hands after rent control
21 began but before some fixed date would never receive rent
22 increases for inflation during the years between 1979 and the
23 date of sale. All other units would receive full inflation
24 increases, even if subsequently sold.

25 From the point of view of a tenant comparing apartments,
26 an owner weighing investment alternatives, or a board seeking
27 predictable, consistent and fair rent levels, this is arbitrary.
28 Similarly situated tenants would have widely varying rents.

1 Similarly situated units would command widely varying rents. No
2 matter how awkward this might become to administer, or how much
3 it might try the public's patience with rent control
4 administration, the Board would be powerless to change it.

5 A second arbitrary distinction would be introduced, in
6 favor of the units--initially estimated at about one thousand
7 (JA at 2063)--which have received NOI indexing from 1979 through
8 property-by-property petitions. The Superior Court determined
9 that those units would keep their increases, irrespective of
10 whether they have changed hands (see JA at 2142).

11 d. Conclusion.

12 A future Rent Board may conclude that the drawbacks
13 outlined in the preceding part of this brief can be made
14 manageable, and that maintaining lower rents in some units
15 justifies the attendant tensions, complications and costs. The
16 Board is not legally obligated to strike the balance in that
17 way. It is not required to adopt a rent increase regime which
18 depends on answers unknown in Berkeley and not available from
19 the experience of any other jurisdiction.

20 5. The Board Is Not Obligated to Deny Base Rent Relief
21 to Post-Rent Control Purchasers.

22 Regulations 1262(C)(3) and 1280 allow base rent
23 adjustments in order to bring current rents in line for
24 properties which had markedly depressed rents when rent control
25 started, and whose rents have therefore remained depressed ever
26 since. The two regulations are critical, because pre-rent
27 control base rents presumptively determine all controlled rents
28 thereafter. The Rent Law undisputedly permits base rent

1 adjustments in appropriate cases; petitioners below acknowledged
2 that such adjustments could be granted--apparently to post-rent
3 control purchasers as well--under other unchallenged subsections
4 of Regulation 1262 (JA at 1834, City's brief at 4:5-11). Base
5 rent increases under Regulations 1262(C)(3) and 1280 should not
6 be flatly denied to post-rent control purchasers, as the
7 Superior Court apparently ordered (JA at 2032, 2065-2066, 2143).

8 The standard of review concerning these regulations, and
9 the Board's discretion to use them to provide a fair return on
10 investment, are as set forth in sections 1 and 2 above. These
11 regulations are not arbitrary or capricious. To the contrary,
12 allowing these increases can cure otherwise permanent and
13 arbitrary differences in rents. Allowing these increases avoids
14 the quagmire of adjudicating landlords' investment expectations
15 (or the simplistic and almost certainly erroneous assumption
16 that no post-rent control buyer expected base rent adjustments).

17 As with the Regulation 1113 inflation adjustment, the
18 decision below on Regulation 1262(C)(3) and 1280 would create
19 permanent rent disparities for units sold since 1979. No law
20 mandates that base rent disparities, and the resulting
21 disparities between current rents for comparable apartments and
22 properties, remain in perpetuity simply because property changed
23 hands after rent control began. If anything, the law requires
24 the contrary: that base rents be equalized. Vega v. City of
25 West Hollywood, supra, requires base rent adjustments to
26 equalize rents for comparable units under a rent control scheme
27 similar to Berkeley's in essential respects, for reasons which
28

1 appear applicable in Berkeley as well. See 223 Cal. App. 3d at
2 1351-1352, see also JA at 1727-1729 (analyzing Vega).

3 Petitioners strove to change a necessity into a virtue
4 below, arguing that rent disparities for like units were an
5 accepted consequence of rent control. Since Vega this is
6 certainly questionable. More to the point, disparities are not
7 a desirable consequence. Even if some level of arbitrariness
8 may be a necessary consequence of controlling rents, that does
9 not make disparities such a virtue that rent control agencies
10 are forbidden to reduce them, even where purchase dates vary.

11 Moreover, the lower court decision presents a Hobson's
12 choice between ignoring legitimate expectations of post-rent
13 control purchasers, on the one hand, or slipping into burdensome
14 and perhaps unresolvable administrative adjudications on the
15 other. Because differentiating post-rent control purchasers
16 under Regulations 1262(C)(3) and 1280 was never suggested to the
17 Board, the Board's record contains no evidence to support the
18 conclusion that purchasers took no account of potential base
19 rent adjustments in setting prices. The availability of such
20 increases (within undefined parameters--JA at 1566-1567) since
21 1981^{2/} suggests that conclusion is wrong, as does the active
22 discussion, going back at least to 1987 (AR at 174), of a
23 regulation like Regulation 1280.

24 Nonetheless, the decision below does not on its face
25 permit the Board to adopt rules granting, or allowing individual
26 landlords to petition for, exceptions to the base rent

27
28 ^{2/}See Regulation 1262 as adopted February 19, 1981, Exhibit A to
the Request for Judicial Note filed herewith.

1 adjustment ban, no matter what the landlords' actual investment
2 expectations. If, in the alternative, the Supreme Court
3 decision is read to allow individual purchasers to get
4 adjustments, administrative and conceptual difficulties would
5 arise like those arising with inflation adjustments tailored to
6 individual post-rent control purchases (see section 4 above).

7 Again, the record does not indicate that any other
8 jurisdiction limits base rent adjustments in the way the
9 decision below contemplates. Petitioners themselves never
10 suggested below that these two regulations must distinguish
11 post-rent control purchasers.

12 In any event, the Superior Court would not permit
13 further consideration of this issue. The decision below leaves
14 so many significant points unexplored in this area that at a
15 minimum it should not stand without a fair opportunity for the
16 Board to deal with the subject.

17 6. The Decision Below Does Not Provide a Public
18 Benefit, and Unwisely Binds Future Rent Boards.

19 Perhaps the court below wished to moderate overall rent
20 increases which petitioners portrayed in melodramatic terms as
21 likely to profoundly change Berkeley (see, e.g., JA at 410-
22 411). Such concern is more properly for the Board, and the
23 voters who elect Board members, than for a court. In any event,
24 the record does not substantiate the effect of modifying
25 Regulation 1113 or Regulations 1262(C)(3) and 1280 as the
26 Superior Court ordered. We do not know how many rents will be
27 lower as a result, how much lower they will be, who will benefit
28 or for how long they will benefit, among other things.

Moreover, a court hazarding its wisdom to make a judgment about these regulations runs a risk that the Board does not. If the Board errs, it can modify or reverse its decisions. If the Superior Court has misjudged, its jurisdiction does not revive because there are reasons to improve the result or correct any error. The basis of its decision, interpretation of an initiative ordinance, puts modification or reversal permanently beyond the reach of any legislative body. In an area where correct answers, practical and legal, remain unsettled, this is a high price to pay.

D. CONCLUSION

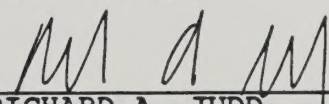
In conclusion, appellant Rent Board urges this Court to reverse the Superior Court's judgment to the extent it disqualifies post-rent control purchasers from receiving rent increases under Regulations 1113, 1262(C)(3) and 1280, and to uphold the regulations now in effect.

Dated: April 16, 1993

Respectfully submitted,

GOLDFARB & LIPMAN

By:



RICHARD A. JUDD
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Rent Stabilization Board

PROOF OF SERVICE BY MAIL

I, Mary Ellen Rescigno, certify and declare as follows:

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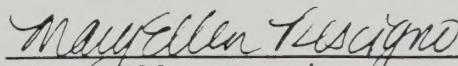
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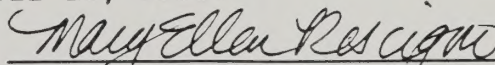
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Mary Ellen Rescigno
Mary Ellen Rescigno

IN THE COURT OF APPEAL OF CALIFORNIA
FIRST APPELLATE DISTRICT
DIVISION FIVE

CITY OF BERKELEY and
SAVE AFFORDABLE HOUSING, et al.,
Petitioners, Respondents & Cross-Appellants,

NO. A059403

v.

CITY OF BERKELEY RENT STABILIZATION BOARD, et al.
Respondents, Appellants & Cross-Respondents.

BERKELEY PROPERTY OWNERS' ASSOCIATION
Appellant, Intervenor & Cross-Respondent.

DAGMAR SEARLE, et al.
Intervenor.

APPEAL FROM THE SUPERIOR COURT OF ALAMEDA COUNTY

HONORABLE JOHN SUTTER, JOSEPH CARSON, RICHARD BARTALINI
JOANNE PARRILLI, and DEMETRIOS AGRETELS, JUDGES

SUPERIOR COURT NO. 683721-5 OH
and NO. 683726-0 (CONSOLIDATED)

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IN THE COURT OF APPEAL OF CALIFORNIA

FIRST APPELLATE DISTRICT

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CITY OF BERKELEY and
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40

STANDARD OF REVIEW

46

ARGUMENT

51

I. THE TRIAL COURT ERRED BY FAILING TO PERCEIVE
THAT THE BOARD'S REGULATIONS WHICH TIED RENT
ADJUSTMENTS TO THE BASE YEAR AND IGNORED
CHANGES IN OWNERSHIP AND THE PURCHASE PRICE
WERE PERFECTLY CONSISTENT WITH THE MNOI SYSTEM
WHICH THE BOARD HAD ADOPTED IN 1981 AND THE
CONSULTANTS HAD ENDORSED.

51

A. The Trial Court Premised Its Decision On
Two Incorrect Assumptions: (1) That Berkeley
Had Adopted A Literal Rate Of Return On
Investment Standard And (2) That Those Investing
In Berkeley Rental Property Relied Solely On The
Property's NOI On The Date Of Sale.

51

1. The Trial Court Erroneously Assumed
That The Board Was Compelled To Employ
A Particular Kind Of Return On Invest-
ment System; In Doing So It Undermined
The Board's Unified fair Return System
Recommended by The Consultants.

52

2. The Trial Court Further Assumed That
Investors Pay A Purchase Price Based
Solely On The Rents Or NOI Generated
By The Property At The Date Of Sale.

54

B. The Trial Court Read Searle II Far Too
Narrowly: By Directing That The Searles,
Who Purchased In 1984, Were Entitled To
An Inflation Adjustment From 1979, The
Court Implicitly, If Not Explicitly,
Supported The Board's Decision To Index
Inflation For All Properties From 1979.

55

C. The Trial Court's Order Places Properties
Purchased After 1984 In A Worse Position
Than Had Searle II Held That 40 Percent
Indexing Was Proper

56

II. THE TRIAL COURT DEVISED ITS OWN FAIR RETURN METHODOLOGY, DISREGARDING THE ARDUOUS AND THOROUGH WORK OF THE BOARD AND ITS CONSULTANTS; IN LIEU OF THE BOARD, THE COURT DEVISED AN INHERENTLY UNMANAGEABLE SYSTEM. 56

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OVERVIEW OF THE CASE

In Searle v. City of Berkeley Rent Stabilization Board (1990) (AO44761), this Court expressed its frustration with the administration of rent controls in Berkeley. It ordered tenants, landlords and the rent board back to the regulatory table to redress past wrongs, and prepare for a future without limitless litigation. Everyone tried.

This Court ordered that the Board adopt a scheme to adjust rents for inflation for all landlords, and find ways to expedite the petition process to guarantee a fair return. The Board engaged in a year of investigation and analysis. It hired experts and held hearings. In the end, after hundreds of speakers, hundreds of hours of debate and an administrative record of some 4,000 pages, the Board adopted a regulatory scheme to provide for 100 percent indexing for inflation, and address historically low and comparable rents.

Then the City of Berkeley sued to stop it.

Eight months and five judges later, the trial court agreed for the most part with the Board. However, it made one error which is so fundamental that it threatens the integrity of the entire rent control scheme if not corrected by this Court. For that reason alone the Berkeley Property Owners Association (BPOA) is compelled to bring this appeal, and request that the Court finish what it ordered and the Board started -- the adjustment of rents in Berkeley to provide owners a fair return.

Put simply, the system adopted and applied in Berkeley throughout the history of rent control has focussed on maintaining the net operating income -- gross rents less operating expenses -- produced by the property on the eve of rent controls ("NOI"). With this Maintenance of Net Operating Income system ("MNOI"), the only relevant issue is the property's NOI, not who owned it or when, or why it was purchased. The NOI determines the adjustments to be made to rents to achieve a fair return on investment.

Following this Court's mandate, the Board determined that the 40 percent indexing which vexed the Searles was an inadequate

adjustment for inflation, and upon the advice of its consultants adopted a 100 percent indexing rate. It also calculated the adjustment necessary to adjust the NOI of each property to reflect indexing at 100 percent of inflation since the inception of rent controls. The rents of all properties were adjusted to this level.

After years of effort, in response to other appellate decisions and the consultants' recommendations and clamor in the community, the Board also enacted regulations to ensure that the rents existing on the eve of rent control represented a fair base from which to determine the level of subsequent rents.

In answer to the litigation brought by the City, the trial court determined that the increases were not excessive, and that the Board had the authority to adopt them. However, the trial court disregarded the Board by holding that NOI for properties purchased after 1979 could receive only the inflation adjustment since the date of purchase. The trial court held that to receive an additional adjustment, the owners of these properties must petition and prove that their purchase price reflected an expectation of achieving an inflation adjustment from 1979.

For the trial court to reach this conclusion, it had to do two things, both of which constitute error. First, it substituted its own discretion for the Board's, and ignored the entire administrative process. Second, it adopted an entirely new system of rent controls which has never existed in Berkeley. The first error is obvious, since the administrative record discloses that the Board considered and rejected this approach. The second is more subtle, and requires an appreciation of the nature of Berkeley's MNOI system, which this brief provides.

This error cannot be permitted to stand. If it does, then each of the thousands of landlords who purchased property after 1979 will be required to petition the Board for the Searle increases. Each post 1979 purchaser will have to prove that he relied on expectations that inflations adjustments would be made and that he would be entitled to them. Each petition could be contested by tenants; each decision could be appealed.

But more important than this administrative nightmare, the foundations of Berkeley rent control would be irreparably damaged. The MNOI system in place for over a decade would be augmented by a new standard for fair return -- the fair return on investment model. This model, explained in detail later in this brief, requires an entirely different determination of fair return. It depends on analysis of the price paid and return achieved rather than the maintenance of NOI. The Board is simply incapable of implementing such a system; neither it, most owners nor most tenants have the resources to run the gauntlet which this new system imposes.

The trial court's decision belies the whole history of Berkeley rent controls. As the following pages show, owners and tenants alike were told long ago that these increases would be made. Throughout the troubled history of Berkeley rent control, beginning with the language of the Ordinance itself, the City and Board have invariably pledged to fairly adjust NOI. No one ever doubted that adjustments would be made, and that those adjustments would be calculated from the inception of rents controls pursuant to Berkeley's MNOI system.

When this court decided Searle v. City of Berkeley Rent Stabilization Board (1988) 197 Cal.App.3d 1251 ("Searle I"), it assumed that the Searles would get relief from an individual adjustment. When the Searles came back to this Court a second time to report their inability to achieve fair return on investment in any meaningful time-frame, this Court ordered the Board to change its procedures and get the problem solved. Thousands of pages in the administrative record attest to the Board's efforts.

During all those years, every owner and purchaser in Berkeley had every right to expect, as the Searles did, that their rents would be adjusted for inflation which had occurred since the onset of rent control. In fact, the Searles themselves are post-1979 purchasers whose rents were adjusted to 100 percent of inflation.

Buyers assumed that inflation increases, like capital

improvements or other entitlements, ran with the property and would benefit them. That the trial court has held otherwise is a stunning shock to the landlord community. Indeed, while this appeal progresses, sales have been postponed, lenders have vanished, and litigation between former sellers and buyers waits in the wings.

The BPOA understands and is mindful of the Court's frustration with this seemingly endless controversy. The frustration is shared when the Board complies with the Court's edict, but is challenged from an entirely new quarter -- the City. The City Council decided in its wisdom to challenge the authority, experience and discretion of the one body elected in Berkeley to control rents, and to ignore the message of the voters who rejected two ballot measures to reduce the Searle increases.

Neither the City's challenge nor the trial court's error may be permitted to stand. The promises of the City and the Board through fifteen years of rent controls must be kept, by reversing the trial court's judgment and affirming the regulations of the Board.

This brief contains over 40 pages of factual summary providing a comprehensive history of Berkeley's rent control, the courts' responses to facial challenges, and the Board's arduous efforts to comply with Searle II and other appellate decisions. This summary both supports this appeal and anticipates the City's appeal challenging 100 percent indexing.

"'Courts should let administrative boards and officers work out their problems with as little judicial interference as possible.'" (Cole v. Oakland Residential Rent Board (1992) 4 Cal.App.4th 693, at 700.) Faced with six years of intransigence, this Court placed the Board on "probation." The Board worked tirelessly and reasonably responded to this Court's mandate. This Court must reject the trial court's order which promises years more of judicial intermeddling. It should reinstate the rule of non-interference and uphold the regulations in their entirety.

STATEMENT OF THE CASE

This appeal is from that portion of a final judgment which struck parts of several regulations adopted by the Berkeley Rent Stabilization Board in the wake of this Court's decision in Searle v. City of Berkeley Rent Stabilization Board (7/18/90 No. A044761) (AR 1B et seq.; 7JA 132, at 2205 et seq.) ("Searle II.")

Following Searle II the Superior Court issued a writ of mandate ordering the Board to comply with this Court's decision. (7JA 133, at 2226.) The Board filed its Return to the Writ on September 17, 1991, indicating compliance with most of the Court's command. (7JA 134, at 2229.) The Board adopted regulations which indexed the base year net operating income (NOI) for all properties by 100 percent of the increase in the Consumer Price Index-Urban Consumer-less shelter (CPI-U-less shelter) since 1979, the base year. (Regulations 110, 1113, 1274; the "Searle" regulations.) These regulations increased 1980 rents by 45 percent of 1980 rents which translated into an average 1991 rent increase of 28 percent; that increase was phased-in for low income tenants.

The City of Berkeley unsuccessfully sought to intervene in Searle II to quash the regulations (7JA 135, at 2269, 2379.)

Meanwhile, on July 22, 1991, a tenants' advocacy group, Save Affordable Housing ("SAH"), had filed a Petition for Writ of Mandate and a Complaint for Injunctive Writ alleging that the Board had failed to comply with CEQA. (1JA 1.) After the City sought permission to file an amended complaint (1JA 13, at 1869), alleging that the regulations violated the Berkeley Rent Stabilization and Eviction for Good Cause Ordinance ("the Ordinance") the Berkeley Property Owners' Association ("BPOA") and Dagmar Searle intervened on October 25, 1991. (1JA 20, 21, at 213, 215). The City filed its amended complaint the same day. (2JA 25, at 209.)

On November 1, 1991, Judge Parelli denied the plaintiffs' motion for a preliminary injunction. (2JA 28, at 371.) She later denied the plaintiffs' motion to strike those portions of the intervenors' complaints which cited Searle II. (3JA 54 at 925.)

Plaintiffs again sought a preliminary injunction, this time

focusing on the Searle regulations. After voluminous briefing (2JA 34, at 388; 3JA 36-45, 58-59 at 720-809, 943-1025; 4JA 60-70, at 1026-1419), the case was transferred to Judge Bartalini. He heard two days of argument (RT 1/9 & 1/10) and denied injunctive relief in February, 1992, (5JA 80 at 1574-1575.)

Plaintiffs then sought an injunction to preclude implementation of Regulations 1262(c)(3) (the "comparable base year") and 1280 ("the historically low rent" or "HLR" regulations. (5JA 73 at 1429.) After extensive briefing, Judge Bartalini recused himself from the case. (5JA 83 at 1710.) The parties submitted new briefs to Judge Carson supporting and opposing permanent injunctive relief which focused on Regulations 1262(c)(3) and 1280. (5JA 81-82, 84-85, at 1577-1709, 1712-1770; 6JA 86-92, at 1771-1924.) Plaintiff SAH then challenged Judge Carson under CCP § 170.6. (6JA 94-96, at 1931-1936) and the case was transferred to Judge Sutter. (6JA 97, at 1938.)

The parties argued extensively on May 26, 1992. (6JA 98 at 1941, RT 5/26.) On July 9, 1992, the trial court issued its tentative decision. (6JA 104 at 2018.) It rejected the CEQA argument and upheld most portions of the regulations, finding that the Board had not exceeded its discretion in indexing NOI at 100 percent of inflation from 1979 or in adopting regulations 1262(c)(3) and 1280. The court held, however, that owners purchasing after rent control took effect had paid a purchase price based on current rents and that such purchasers were entitled to 100 percent indexing only from the date of purchase. Moreover, the court held that Regulations 1262(c) and 1280 would not apply to any owners who purchased after 1979. The court stated that those owners who may have paid a price which included the expectation of an inflation adjustment could seek relief on through IRA petitions. The court did not explain the recourse available for owners of properties it deemed ineligible for comparable rent and HLR adjustments. BPOA appeals from that aspect of the judgment adversely affecting properties purchased after 1979.

After receipt of responses to his decision (6JA 107-107-118,

at 2046-2138), the court issued its Statement of Decision affirming its Tentative Decision and listing factors the Board could consider in deciding petitions by post-1979 purchasers who sought pre-purchase inflation adjustments. (7JA 119, at 2139, 2140-2142.)

Judgment was entered on September 17, 1992. (7JA 126 at 2184.) On October 1, 1992, BPOA filed a timely notice of appeal from that part of the judgment affecting properties purchased after 1979. Its appeal is from a final Superior Court judgment. (CCP § 904.1) The City and SAH subsequently cross-appealed from those parts of the opinion upholding most of the regulations. (7JA 129, 130 at 2197, 2200.) This Court later dismissed SAH's appeal.

STATEMENT OF FACTS

The central question before the Court is whether the Board acted reasonably when it adopted the following regulations: (1) Regulations 1100, 1113 and 1274 which sought to implement this Court's order in Searle II to adjust rents to account for inflation; (2) Regulation 1280, drafted to remedy historically low rents; and (3) Regulation 1262(c)(3), drafted to remedy the problem caused by below market base-year rents by raising base-year rents to those of comparable units in conformity with the holding in Vega v. City of West Hollywood (1990) 223 Cal.App.3d 1342. This Court's analysis must take cognizance of the Board's prior regulatory history, prior court decisions, and information and advice the Board obtained from various experts and the public prior to adopting the regulations. While the instant appeal only challenges a portion of the trial court's decision, the City's cross-appeal compels a plenary review of the events culminating in the regulations before the Court. The Statement of Facts is intended to assist the Court's consideration of both appeals.

A Tale of Two Systems

The instant appeal results from the collision of two rent control models: the one which the Board adopted and enforced for a decade and a particular model which appeared on the face of the

Ordinance and construed by the courts in responding to facial challenges. The BPOA submits that the trial court has compelled the Board to a particular fair return model -- the fair rate of return on investment model, although that complex and much-maligned system was not chosen by the Board as its fair return model.

As jurisdictions adopted rent control in the 1970s, different standards evolved governing owners' entitlement to rent increases. Kenneth Baar detailed these standards in his seminal article, Guidelines for Drafting Rent Control Laws: Lessons of a Decade (1983) 35 Rutgers L.Rev. 723, (hereinafter, "Guidelines.") The consultants the Board retained to guide its response to Searle II also describe these systems in their reports on fair return standards. (AR 78-88B; 443-501B.)

The **return on value** standard allows rent increases to cover operating expenses and to yield a specific rate of return on the market value of the property. (Guidelines, at 797; AR 482-483B.)

The **rate of return on investment** standard provides owners with rents sufficient to cover operating expenses and debt service plus a specified rate of return on their cash investment. (Guidelines, at 790, AR 479-482B.)

The **maintenance of base year net operating income system** ("MNOI") ties rents to a period prior to the inception of rent control -- the base year. This system assures owners that the property's base year net operating income -- gross rents less operating expenses ("NOI") will not diminish. Current rent equals base rent plus operating cost increases since the base year. Purchase price, mortgage payments and changes in ownership are irrelevant to rent levels under this system. (Guidelines, at 809-811; AR 477-478B.)

As we will show, give the choice of choosing the particular fair return model to use, the Board has chosen the MNOI system and adhered to it for over a decade. This cannot be overemphasized. The portions of the regulations voided below were perfectly consistent with the Board's established fair return system. The trial court, however, reading the Ordinance too literally, read the

Ordinance as limiting the Board to a particular fair return system and found that the regulations conflicted with that system.

1980: Berkeley Enacts An Ordinance Which, On Its Face, Includes Both MNOI and Rate of Return On Investment Components.

In June, 1980 Berkeley voters enacted Initiative Measure D, the Berkeley Rent Stabilization and Eviction for Good Cause Ordinance. (Ordinance & Regulations filed under separate cover.)¹ It established an appointed rent board, with authority to "Set rents at fair and equitable levels in view of and in order to achieve the purposes of the Ordinance." (§ 6.f.(5).)

The Ordinance set the base rent as the legal rent due and owing on May 31, 1980, (§ 10)² and established two general mechanisms by which owners could increase their base rents. Section 11 directed the Board to annually adjust rents to compensate owners for inflationary increases in operating expenses. These annual adjustments (AGAs) permitted owners to maintain their base year NOI in actual dollars. Section 12 provided owners dissatisfied with the AGAs recourse to individual rent adjustment (IRAs) to obtain a fair return. Section 11 was the MNOI component of the Ordinance; section 12 explicitly referred to the landlord's rate of return on investment:

Among the factors listed in section 12 were:

The landlord's rate of return on investment. In determining such return, all relevant factors, including

¹ The Ordinance recited that in 1973 the City Council had declared a housing emergency due to "steady rising rents, a shortage of decent housing and an increased deterioration of the existing housing stock in the city. (§ 2c.) Among the purposes of the Ordinance were "to protect tenants from unwarranted rent increases . . . in order to help maintain the diversity of the Berkeley community." (§ 3.)

² The legal base year rent was tied to two prior ordinances. Ordinance 5109, enacted in 1978, required owners to rollback rents and pass on their Proposition 13 property tax savings to tenants. (AR 589B.) Ordinance 5212, enacted in November, 1979, limited rent increases during the first six months of 1980. (AR 582B.)

but not limited to the following shall be considered: the landlord's actual cash down payment, method of financing the property, and any federal or state tax benefits accruing to landlord as a result of ownership of the property. (§ 12(c)(8).)

Section 12(i), the so-called safety-valve provision, stated:

No provision in this Ordinance shall be applied so as to prohibit the Board from granting an individual adjustment that is demonstrated necessary by the landlord to provide the landlord with a fair return on investment.

Section 12's language suggested that Berkeley would follow a "rate of return on investment" model of fair return. Owners were to determine their profit and apparently calculate the rate of return their profit yielded on their cash investment. The Ordinance assured them that their right to a fair return would supersede other provisions in the Ordinance.

1981: Divergent Paths: The Board Adopts An MNOI Methodology While Courts Consider The Propriety Of Berkeley's Non-Existent Rate of Return Approach.

Berkeley Applies The MNOI Standard To Both Annual General Adjustments And Individual Rent Adjustments.

In 1981, Berkeley adopted regulations establishing the MNOI system for IRA petitions brought under section 12 of the Ordinance. (See former Regulations 1262 et seq., filed herewith; Guidelines, at 785, 810, n.338) Berkeley's system was among those which "provide[d] for maintenance of base period net operating incomes, without any adjustment for inflation subsequent to the base period." (Guidelines, at 811 and n.341.) In this **property-specific** system, the Board -- with sparse exceptions -- would only increase a property's rent when necessary to offset increases in operating expenses and capital improvements not covered by the AGAs to maintain the dollar amount of the property's base year NOI (gross revenues less operating expenses.) The Board set no specific "rate of return" which owners could secure via the IRA process and promulgated no standards other than maintenance of base year NOI which would have allowed an owner to earn a particular rate of return on investment. (See, Reg. 1275, which repeated the

language of Ordinance section 12(i), but included no standards.)

Baar's article lauded the MNOI standard for individual adjustments. After noting the difficulty of designating a particular percentage rate of return as "fair",³ he stated:

In addition to being conceptually consistent with the "stabilization" purpose of rent controls, the maintenance-of-net-operating-income standard has several advantages over other types of standards. . . . [I]t avoids the circularity associated with return-on-value standards, **and it does not base fair return levels on the particular purchase price, investment, or financing arrangement of the owner.** It also offers the most reasonable type of incentive for increased operating and maintenance expenditures, a dollar-for-dollar pass through, to which all owners are entitled regardless of whether their pre-rent control levels were high or low. Finally, it is the only standard that assures that a landlord's net operating income will not be reduced by rent control. [emphasis added.]

Guidelines, at 810-811. The MNOI standard relied solely on the NOI of the property on the eve of rent control (the base year). It was not tied to the purchase price, changes in ownership, date of purchase, or the owner's expectation of current or future income.⁴

³ Guidelines, at 790-797, 808-809.

⁴ See, e.g., various regulations adopted in 1981. Regulation 1262 stated that a property's base year NOI "shall be presumed to provide the landlord of that **property** with at least a fair return on investment." (Emph. added.) The regulation set forth circumstances which existed during the base year which would cause the application of the base year NOI to result in "gross inequity to either the landlord or the tenant."

Regulation 1263 defined a **property's** NOI as the property's gross income less property taxes, maintenance and operating expenses and the amortized cost of capital improvements.

Regulation 1264 provided that landlords "shall be permitted to maintain the net operating income produced by a **property** in the base year, or as adjusted pursuant to Section 1262(C)."

Regulation 1265 listed allowable maintenance and operating expenses, expressly excluding mortgage principal and interest.

Regulation 1268 permitted a one-time upward rent adjustment for those **properties** for which there had been minimal or no increases for the years 1976-1979.

Regulation 1270 permitted a ten percent rent increase for each additional tenant in a **unit** over the number of tenants during the period June, 1979 to May 31, 1980.

1982: The Voters Strengthen The Ordinance And Amend The Charter To Place Rent Control Policy In The Hands Of An Elected Board.

Berkeley voters strengthened the Ordinance in the June, 1982 election, amending the Ordinance to essentially its present form. Though the MNOI regulations had been in effect for a while, the voters did not amend the Ordinance to annul that system. The voters also amended the City Charter to vest control of rental housing policy in an **elected** Board, taking power from Council members who formerly appointed Board members. (City Charter §§120 et seq, attached hereto.)

1985: Ruling On the Searles' IRA Petition, The Board States What Has Been True From The Outset Of Berkeley Rent Control: Maintenance Of Base Year NOI Is Berkeley's Fair Return System.

In deciding the Searles' first appeal, the Board explained that maintenance of base year net operating income provided all the fair return to which the Searles and other owners were entitled:

The fair return standard of the Berkeley Rent Stabilization Ordinance is commonly known as maintenance of net operating income. . . . The net operating income standard does not try to determine a particular rate of return as fair relative to each owner's investment, but simply preserves the net operating income the property generated in the free market prior to government regulation.

(1JA, at 63 in Searle II record.)

Regulations 1272 and 1273 precluded rent increases based on increased interest or other expenses due to refinancing or purchase if the owner could have reasonably foreseen that the rent schedule in effect would not cover the higher interest costs. Regulation 1276 essentially precluded any upward rent adjustment based on increased debt service after June, 1980.

Regulation 1275 covered fair return on investment. It mirrored section 12(i) of the Ordinance, but stated that until the Board adopted fair return guidelines, "the rent ceiling necessary to provide a fair return on investment shall be calculated according to sections 1262-1274 of the Board's regulations."

1985-1987: The Board Adopts A Partial Indexing Formula; Consistent With The MNOI System, It Disregards Changes In Ownership And Grants Inflation Adjustments From The Base Year.

In 1985, the Board retained Ken Baar to recommend how the Board should adjust rents to account for inflation. After rejecting a rate of return on investment standard, Baar studied the historical relationship of rents to inflation and concluded that NOI had increased at only fifty percent of the CPI since 1970.⁵

In August, 1986, at oral argument in Amberhill Properties v. City of Berkeley (1987) 814 F.2d 1340, 1341, the Board promised to consider the effect of inflation.

In 1987, the Board amended several regulations. Regulation 1262(C) was amended to limit the opportunity to obtain adjustments to base year NOI. Regulation 1264 was amended to allow an owner to file an IRA petition to obtain an adjustment to the base year NOI equal to 40 percent of the percentage increase in the CPI since June, 1980. Adhering to the MNOI system, the regulation did not differentiate between properties which had changed hands since 1979 and those which had not; as ever, the focus was on the property, not changes in ownership or purchase price.⁶

In its final decision on the Searles' appeal, the Board adjusted the property's base year NOI by 15.7 percent to reflect the 39.3 percent CPI increase between 1980 and 1986. The Searles' purchase of the property in 1984 was not relevant.

In 1987, the Board also amended Regulation 1275, the fair return on investment regulation. The amendment listed factors the Board would consider in an IRA petition, but failed to state **how** the Board would weigh those factors.

⁵ Baar's report is found at 2JA, at 51-60 in the record of the Searle II litigation. Reports submitted by St. John (AR 1424B) and the Board's consultants discuss Baar's study. (AR 92B.)

⁶ The original and 1987 versions of Reg. 1264 are attached to Appellants' Opening Brief in Searle II.

1983-1987: The Courts Respond To Facial Challenges Assuming That Rent Control Boards Are Literally Implementing A Rate Of Return On Investment Standard.

Cotati: The Court Upholds The Return on Investment Standard But Notes That The Rent Adjustment Process Must Account For Inflation.

While the Board was adopting regulations implementing the MNOI approach for both AGAs and IRAs, the courts responded to **facial** challenges to rent control ordinances by focusing on the literal terms of the ordinances, a response continued until Searle II.

By the summer of 1983, the Fisher litigation and rent control cases from Cotati reached this Court raising similar issues. On July 5, 1983, this Court heard oral arguments in the two cases. After the "effect of inflation" issue was raised during argument,⁷ counsel for the City wrote this Court to assure the Court that Berkeley would consider the effect of inflation in adjusting rents:

I am concerned that during oral argument in these cases today, I may have given the Court the impression that I was asserting that the Berkeley and Cotati rent control ordinances may be interpreted only in certain narrow ways. To alleviate any misconceptions I might have created, I respectfully request that you temporarily vacate the submissions of these cases in order to receive the following concessions:

1. The City of Berkeley hereby concedes that the term "fair return", as used in "fair return on investment" in Sections 12(c) and 12(i) of the Ordinance, may reasonably be interpreted to permit the Board to consider and allow for any decrease in the purchasing power of the return due to inflation.

A similar concession was made as to Cotati. (6JA, at 2099.)

In October, 1983, this Court decided Cotati Alliance for Better Housing v. City of Cotati (1983) 148 Cal.App.3d 280, upholding the constitutionality of an ordinance that on its face

⁷ Fisher v. City of Berkeley (1984) 37 Cal.3d 644, 682, n.37.

closely resembled Berkeley's ordinance by providing for "fair return on investment" in individual adjustments. (148 Cal.App.3d at 285 & n.3.) The Court rejected the return on value standard, upholding the return on investment model. The opinion assumed that Cotati would implement return on investment literally for individual adjustments and emphasized the flexibility inherent in that standard. It cautioned the Board to consider inflation:

If the net operating profit of a landlord continues to be the identical number of dollars, there is in time a real diminution to the landlord which eventually becomes confiscatory.

148 Cal.App.3d at 293.

In summarizing its view of "proper rent," the Court addressed implementation of a return on investment standard:

Rent which meets the minimum standards of being fair and reasonable is that amount which will permit the property to generate income sufficient to cover the costs of operation and the servicing of reasonable financing and to ensure the return of a reasonable profit.

(148 Cal.App.3d at 294.)

Cotati's primary impact stemmed from its directive that rent boards must consider inflation in adjusting rents. Baar read Cotati as having "held that freezing net operating income during an inflationary period is confiscatory." (Guidelines, at 814, n.350.)⁸ The City of Cotati responded by adjusting NOI across-the-board by 100 percent of the CPI. (See, AR 108B.)

⁸ While praising this Cotati for its "creativity", Baar concluded that the opinion had unintentionally demonstrated that "it may be impossible to develop a return-on-investment standard which is both reasonable and practical." (Guidelines, at 795-796.)

1984: Fisher: Following Cotati, The Court Upholds Berkeley's Return On Investment Standard, Admonishes Berkeley To Account For Inflation And, Responding To A Facial Challenge, Does Not Address The MNOI System Berkeley Has Adopted.

Fisher, however, stayed only briefly in this Court. The Supreme Court delivered what would become the common law authority on most aspects of California -- and Berkeley -- rent control: Fisher v. City of Berkeley (1984) 37 Cal.3d 644. Besides reiterating Cotati's teaching that adjustments for the effect of inflation were constitutionally required, Fisher, however, was largely irrelevant to the operation of Berkeley's MNOI standard.

As in Cotati, the parties focused on the propriety of a return on investment versus a return on value standard. Plaintiffs contended that the return on investment standard was unconstitutional, but that if upheld, the Board should be required to adjust the initial investment for inflation and apply a rate of return to that adjusted figure; the City responded that the rate of return could be adjusted from as interest rates changed. (City's Petition for Hearing at 6.)

Unaware that Berkeley had implemented a return on investment through the MNOI model, the Supreme Court focused on the issue presented to the Court of Appeal:

The primary dispute in the trial court and one of the primary substantive questions posed on this appeal concerns whether a rent control ordinance is facially constitutional if it provides that a landlord is to receive a fair return on his investment rather than a fair return on the value of his property.

(37 Cal.3d at 679, *emph. added.*) The Court noted that Berkeley employed the MNOI standard for AGAs in section 11 and the return on investment standard governing IRAs pursuant to section 12. (37 Cal.3d at 679, n.32.) Hence, the Court presupposed that any inflation adjustments would be obtained after an IRA petition applying a literal rate of return on investment standard. (See,

e.g., 37 Cal.3d at 682, n.36; 37 Cal.3d at 684-685.)⁹

The Court did address the Board's duty to adjust profits to account for inflation. Following Cotati, the Court instructed the Board that it "may not indefinitely freeze the dollar amount of those profits without eventually causing confiscatory results[]" (37 Cal.3d at 683), quoting Cotati's statement that "'If the net operating profit of a landlord continues to be the identical number of dollars, there is in time a real diminution to the landlord which eventually becomes confiscatory.'" (37 Cal.3d at 683.) Fisher's main impact was to reaffirm the validity of the return on investment standard and to admonish the Board to account for inflation when adjusting rents.

1985: In Fisher's Wake, Trial And Appellate Courts Cling To The View That Berkeley Applies A Return On Investment Standard.

In 1985, a plaintiff in the Fisher litigation, Levin-Zemel, Inc., filed an administrative mandamus petition arguing that the Board was required to grant owners a fair return on investment and adjust base year NOI to account for inflation. Judge Sutter agreed. In his Tentative Decision, he invoked the return on investment language in the Ordinance and set forth a methodology for determining the fairness of base year NOI based on whether the NOI earned an eight percent return in the base year. (TD at 15-16.)

He ordered the Board to adopt standards to define "investment" applicable to IRA petitions seeking adjustment of the base year NOI. (TD at 22-23.) The Board appealed, but dismissed its appeal. (Ex. C to Tentative Decision. at ^{754,} 2167x)

⁹ The Court appeared to confuse "profit" (or cash return after all expenses, including financing, are deducted from revenue) with NOI (which does not include a deduction for mortgage payments.) The Court states that section 11 ensured that owners retained the same dollar amount of "profit" and section 12 allowed owners to seek an increase in that amount. (37 Cal.3d at 688-689.) In fact, Berkeley froze the dollar amount of the property's base year NOI, not freeze the dollar amount of an owner's "profit."

1988: This Court Decides Searle I; It Assumes The IRA Process Provides Owners With A Fair Return On Investment.

In 1988, this Court decided Searle v. Berkeley Rent Stabilization Board (1988) 197 Cal.App.3d 1251. (Searle I.) It upheld a regulation denying new owners AGAs from years preceding their purchase which had been lost due to the prior owner's non-registration. Assuming that Berkeley was construing the phrase "return on investment" literally (197 Cal.App.3d at 1256-1257 & n. 3), the Court flatly rejected the contention that the Board would not consider a property's purchase price in an IRA petition, citing section 12(i) of the Ordinance. (197 Cal.App.3d at 1258, n.5.)

1990: Searle II: This Court Orders The Board To Develop A Rational Method Of Indexing For Inflation, Requires That Such Inflation Adjustments Be Made For All Owners And Orders The Board To Revise Its Fair Return Regulation.

On July 18, 1990, this Court rendered its opinion in Searle v. City of Berkeley Rent Stabilization Board. (AR 1-20B.) The Court noted that Fisher had "observed that continued failure to adjust base year NOI for inflation would eventually produce confiscatory results" (AR 7B), and found no "rational basis for the choice of 40 percent indexing." (AR 8B.)

The Court held that the Board had acted irrationally "to index for inflation from June 1980 in order to maintain the net operating income produced by property in 1979." (AR 8B.) Although the Searles had purchased their property in 1984 (AR 3B), adjustments would be calculated from the eve of rent control, i.e., 1979: "[H]ow the base year net operating income was produced -- whether it included inflated rents or not --is irrelevant to the calculation of losses due to inflation since then." (AR 10B.)

The Court then noted that "every landlord in Berkeley has experienced the effect of inflation on the dollar amount of base year NOI. It follows that every landlord is now eligible for NOI inflation indexing." (AR 11B.) The Court held that "There is no rational basis for relegating NOI inflation indexing to the individual petition process, especially when the applicable

regulation specifies that everyone's base year NOI will be raised by 40 percent of the CPI increase regardless of individual circumstances." (AR 12B.)

The Court also held that the fair return regulation must include specific guidelines to assist landlords achieve a fair return. (AR 13-14B.) The Court summarized its decision:

To summarize, six years after Fisher, the Board has yet to adopt a regulation under which landlords can effectively petition for a fair return on their investment. Four years after Cotati, the Board adopted a regulation permitting NOI inflation indexing, but that regulation also is fatally defective. The Board has proffered no rational basis, nor can one easily be imagined, for indexing from June 1980 in order to maintain the net operating of base year 1979. While the decision to index by only 40 percent of the increase in the consumer price index appears almost as arbitrary, an even more serious defect of Regulation 1264 is that it provides constitutionally-mandated inflation relief only to those, such as Landlords herein, willing and able to go through the costly and time-consuming individual petition process. And even for those "lucky few" it does not provide for ongoing maintenance of net operating income in the face of continuing inflation. If the erosion of NOI by inflation were taken into account in the annual general rent adjustments, indexing by less than 100 percent could conceivably be justified, since additional relief would remain available through individual petition for a fair return on investment under revised Regulation 1275.

(AR 14-15B.)

On February 7, 1991, the Superior Court issued a peremptory writ of mandate compelling the Board to take specific action by September 17, 1991. (7JA 133, at 2227; AR 48B.) Specifically, the writ ordered the Board to conform its regulation governing inflation adjustments (Reg. 1264) and fair return on investment (Reg. 1275) "to the principles set forth in the July 18, 1990 decision of the Court of Appeal. (Id.)

Searle II was the culmination of years of effort by owners to bring fairness to Berkeley's system. The Ordinance on its face had promised a fair return, but the Board had neither defined it nor provided it. Fisher had raised owners' expectations that the Board

would account for inflation; these expectations were raised again when the Board adopted its 40 percent indexing regulation in 1987. Berkeley investors assumed that conditions would improve; since Berkeley had the MNOI system, new owners would benefit from any adjustment which indexed inflation from the base year. In November, 1990, the moderate rent control candidates assumed a majority on the Board. Owners' rising expectations are reflected in increased gross rent multipliers after 1985.¹⁰

1991: The Board Responds To Searle II By Retaining A Consultant, Holding Numerous Public Meetings, And Adopting Regulations Which Conform To The Court's Mandate, Consistent With The Board's Historic MNOI Fair Return Standard.

The Court's opinion obligated the Board to adopt regulations which would adjust rents for inflation for all properties without requiring IRA petitions and which would install a comprehensible and not unduly burdensome criterion for owners who sought a fair return. The Court had not compelled the Board to index by a particular percentage of inflation; but in stating that less than 100 percent indexing was "conceivable" had indicated that 100 percent indexing would be acceptable, if not expected. They began their task cognizant of their pre-existing property-specific MNOI system on which tenants, owners and investors had relied. Moreover, while the Court had faulted facets of Regulation 1264 which limited inflation adjustments to 40 percent through the IRA process, the Court had not questioned the Board's power to adjust rents for all properties from the base year; indeed, although the Searles had purchased their property in 1984, the Court had directed that indexing occur from at least 1979.

¹⁰ These expectations were reflected in rising property values. St. John, The Impact of Rent Controls on Property Value, showing increased gross rent multipliers after 1985. (AR 1544B.)

The Board Retains An Experienced Consultant And The City Council Gets Involved.

The Board allocated \$60,000 for a consultant (AR 33B), and on February 21, 1991, the Board retained the exceptionally well qualified (AR 918-930B) consulting firm of Hamilton, Rabinowitz & Alschuler ("HR&A") to "conduct a study of fair return and indexing percentage to be used in Berkeley." (AR 40-41B).

The Board directed the consultants to advise it on the appropriate index to use the level of indexing to recommend, the treatment of debt service, the incorporation of indexing in the AGA or IRA process, the best way to minimize the needs for individual IRA fair return petitions, competing definitions of fair return, the relationship between indexing and fair return and the use of objective criteria to measure fair return. (AR 605-609B.)

On May 15, 1991 the City Council Housing Subcommittee prepared a Statement of Housing Problems. (AR 939B et seq.) While expressing concern about impending rent increases (AR 939B,) the statement noted that 4,500 rental units had left the market in the 1980s and (AR 939B) and that "[m]aintenance of the rental housing stock is a serious concern." (AR 940B.) On June 10, 1991, Stephen Barton, secretary to the City Council Housing Subcommittee, advised the subcommittee that census data had revealed a net loss of 3,100 rental units between 1980 and 1990. (AR 952B.)

The Consultants Make Their Initial Appearance; They Recommend 100 percent Indexing For All Properties Using The AGA Process.

On June 17, 1991, HR&A representatives appeared before the Board (AR 902B et seq.) and submitted a report summarizing "Indexing Operating Costs and Net Operating Income in Accordance with the Searle Decision and the Berkeley Rent Stabilization Ordinance." (AR 963B et seq.) It examined indexing in other jurisdictions and discussed different price indices. It noted that expenses had taken an increasingly larger share of rent receipts over the 1981-1989 period, increasing from about 44 percent to about 54 percent of receipts. (AR 972B.)

Mr. Hamilton explained to the Board that "CPI is the standard

used by virtually all organizations" and that the "number of exceptions to 100% is quite limited." (AR 903B.) He advised the Board to use CPI-U (CPI Urban) less shelter index to avoid circularity. (AR 907-908B.) He further recommended that the Board index NOI and not rents. (Id.)

He stated the consultants "do not see a technical justification for not using the full 100% of the CPI. Because that is in fact the indicator of inflation." (AR 909B.) Using 100 percent of inflation would "give the Board a fair technical argument against separately indexing debt service[,]" noting how difficult it would be to justify separately indexing debt service, which is often variable. (AR 909B.) He recommended the efficiency of across-the-board indexing as part of the AGA process. (AR 909B.) Justifying 100% indexing, Hamilton stated:

If you want to index NOI by the price index then you should index NOI by the price index not by a portion of it. People don't pay 40% of the increased price of milk they pay 100% of the increased price of milk. So if you decide that NOI is the basic unit you're interested in, which is what this set of ordinances and regulations do, . . . we can't find a persuasive case for using less than the full value of the index.

(AR 914B.)

The Consultants Submit Their Preliminary Report And Address The Board On Fair Return: They Note The Existence Of Different Fair Return Standards, Set Forth Methods Of Linking Fair Return And Inflation Indexing Standards And Reaffirm Their Recommendation To Index At 100 Percent Of Inflation.

On July 29, 1991, the consultants presented their Preliminary Report on "Standards Of Fair Return On Investment: Consistency With The Searle Decision And The Berkeley Rent Stabilization Ordinance." (AR 78-88B, 89B.) The report outlined general approaches to fair return (AR 80B) and set forth approaches which linked fair return standards with NOI indexing standards. (AR 88B). Maintenance of base year NOI could be achieved by indexing NOI at 100 percent of CPI in the AGAs. (AR 88B.)

That evening, the consultants addressed the Board on fair return. (AR 865B et seq.) Hamilton noted that "There is no technical answer to the question, what is fair" and that different definitions of fair return existed, including the MNOI (adopted by Berkeley) and a return on investment approach. (AR 868-869B.) Hamilton discussed three alternatives linking the AGA and IRA process, including simply allowing 100 percent inflation indexing for both AGAs and IRAs. (AR 877B.)

Hamilton repeated that 100 percent of CPI is the technically most defensible way to price index the base year. (AR 885-886B.) Asked by Commissioner Olds about a potential lawsuit in "sue happy Berkeley," Hamilton stated: "If we were appearing as expert witnesses . . . we would have to say as we have said to you that 100% is the most sensible, technical index we can see." (AR 887B.)

The Consultants' Final Review Draft On Index Reaffirms Their Recommendation For 100 Percent Indexing Of NOI Via The AGA Process With No Distinction Made Between Properties On The Basis Of Debt Service; The Proposal Is Consistent With The Board's Existing MNOI System Which Has Treated Debt Service As Irrelevant.

On July 30, 1991, HR&A submitted its Final Review Draft of its study, "Inflation Indexing in Berkeley Rent Regulation In The Aftermath Of The Searle Decision." (AR 92-185B.) The Report examined ordinances from other jurisdictions, considered what index to use for indexing inflation, discussed the appropriate base year, discussed the treatment of debt service and made several recommendations. (Id.) The report stated that of the seven communities which focus on NOI all but Berkeley "treat the AGA process as the proper across-the-board vehicle for keeping rents or landlord net operating income indexed for inflation." (AR 104B.)

The report noted that even Santa Monica had recognized that indexing the entire NOI at less than 100 percent of the CPI reduces the real value of NOI, increases the percentage of the rent used to pay operating expenses, leads to the decline in the real value of property and the amount owners spend on maintenance. (AR 107B.)

The consultants stated that after the Cotati decision, Cotati revised its regulations to permit NOI to increase at 100 percent of the CPI. (AR 108B.) Among the report's conclusions were:

- (a) The nearly universal method of indexing for inflation, if the jurisdiction elects to index for inflation, is the general, across-the-board annual adjustment, not the individual petition process.
- (e) Where NOI is directly indexed, the CPI-U [Consumer Price Index - Urban Consumers] is the standard price index employed, and the share of it that is permitted ranged from 40% to 100%, **though it seems to be clearly rising over time.**

(AR 114B, emph. added.)

The report questioned the accuracy of Berkeley's AGA figures. (AR 119-120B.) The economist retained to calculate the 1988-1990 AGAs found that the 1982-1987 calculations had failed to include various taxes in the operating cost base. (AR 123-124B.)¹¹

The report reaffirmed that the percentage of rent required to cover operating costs (the operating ratio) had increased from 44 percent to 55 percent in 1990. Hence, "the percentage share of gross rents represented by landlord NOI has fallen from 56% to 45%, or by about one-fifth." (AR 124B.) The report further stated that "it is a matter of technical certainty, not opinion, that in the absence of full and general adjustment of NOI for inflation, operating ratios in Berkeley will continue to increase as they have throughout the period of rent stabilization." (AR 151B.)

The report stated that the CPI-U (Consumer Price Index - Urban Consumers) was the "overwhelming choice among general price indices used by rent regulating localities." (AR 131B.) A question still existed, however, whether CPI-U less the shelter component was a better price index to avoid circularity. (AR B134.)

¹¹ In August, 1991, Robert Clucas and Michael St. John presented a report to the Board: Berkeley's AGA Studies A Retrospective Evaluation: 1980-1991. (AR 191-211B.) They found that the Board's 1980-1991 "AGA studies under-reported actual cost increases by 20 to 30 percent" and that an upward adjustments in rent by 11.6% would be required to correct the error. (AR 192B.)

The consultants next considered whether full 100 percent or partial indexing was appropriate (AR 134B et seq.) They criticized Santa Monica's view that the portion of net income devoted to debt service need not be indexed, noting that the portion of NOI devoted to debt service varied, the prevalence of variable rate mortgages, and Santa Monica incorrect assumption "that indexing the non-debt service component of NOI at only 40% of the rate of inflation will in fact permit the purchasing power of that component to keep pace with inflation[]" (AR 146B), an assumption "necessarily incorrect as a matter of mathematics." (AR 147B.) As the report stated:

The consultants further emphasized that the shrinkage of NOI as a component of the rent dollar was the only "mathematically possible" effect of partial indexing:

If operating costs are indexed at the full inflation rate and NOI is indexed at only 40% of that rate, NOI must shrink in relative terms. If . . . the portion of NOI which the landlord must use to pay debt service cannot either grow or shrink, then it must occupy an increasing share of the shrinking NOI. . . .

Put simply, it is a mathematical certainty, not an assertion, than any system which provides for full adjustment to inflationary changes in operating costs and only partial indexing of landlord NOI will, unless operating costs pursue a sustained course opposite to general price trends in the economy, result in erosion of the real value of NOI.

(AR 147-148B.)¹²

Further discussing the debt service issue (AR 157-169B), the report noted that except under highly restricted exceptions, Berkeley does not permit owners to pass through increased debt service costs to tenants. (AR 162B.) Noting arguments favoring and opposing indexing of debt service, the report stated:

[N]o technical basis [existed] for the distinction between the general process for handling adjustments for

¹² The consultants stated that when recent data was applied to the Baar methodology on which Berkeley had based its decision to index NOI at 40 percent of the CPI, the Baar approach supported indexing at **greater** than 100 percent of inflation. (AR 149-150B.)

increases in landlord operating costs, on the one hand, and for a given percentage of the change in the general price index, on the other.

(AR 172B.)

The consultants also analyzed the appropriate base year. In Berkeley's "kind of system, the base year becomes the point of reference upon which the fairness and other major characteristics of the system depend regardless of how many years or decades the regulatory regime may continue in force." (AR 152B.) The consultants explained that 1978 might be the more accurate base year in light of Measure I (AR 154B), but recommended against changing the base year from 1979. (AR 155-156B, 176-177B.)

The consultants made several "Conclusory Observations":

(f) It is a mathematical certainty that indexing of landlord operating costs at their full rate of inflation while indexing landlord NOI at a fraction of the rate of inflation will, over time, reduce the share of gross landlord income represented by NOI and erode the real value of NOI. The data available in Berkeley indicate that this has in fact occurred throughout the period of rent stabilization. If Berkeley policies remain unchanged, it is mathematically inevitable that this trend will continue.

(i) The explicit or implicit assumption that landlord debt service obligations are not sensitive to inflation impact, which underlies the decisions of some localities to use a partial index reading as an inflation adjustment, is clearly incorrect with respect to some portion of properties, especially those financed from the late 1970s through the mid 1980s. . . .

(AR 176-177B.)

The consultants made the following recommendations. They envisaged a matching of the AGA and IRA process with 100 percent indexing for all properties from 1979; this recommendation provided the Board with a straightforward, efficient system consistent with the existing property specific MNOI standard:

The consultants recommend a shift from the IRA to the AGA process for all indexing for inflation of both landlord operating costs and landlord NOI.

Landlord NOI should be indexed using 100% of the annual change

in the Consumer Price Index for urban consumers in the San Francisco-Oakland-San Jose region less the shelter component of that index.

The formula for calculating the permitted overall rent adjustment to account for inflation should be as follows:

$$\begin{aligned} & \% \text{ share [of rental receipts] which is} \\ & \text{operating cost X change in operating cost} + \\ & \% \text{ rent share which is NOI X \% change in} \\ & \text{inflation index} = \\ & \% \text{ rent increase permitted to account for} \\ & \text{inflation.} \end{aligned}$$

This formula would both account for operating cost increases and maintain the real purchasing power of NOI.

The consultants recommend that the current amended base year of 1979 be maintained [although] as a purely technical matter an earlier base year would be superior as a microcosm of the market situation that existed before rent regulation . . . [but] the consultants do not recommend following the technically superior course.

(AR 182-185B.)

Summer, 1991: The Consultants Meet With The Board And The Public: They Reaffirm Their Recommendation Of 100% Indexing For All Properties, A Linkage Of The IRA And AGA Process And Reject Any Distinction Between Properties Purchased Before And After 1979; Board Members Recognize That 100 Percent Indexing For All Properties Is The Most Practical Approach.

On the morning of August 16, 1991, the consultants, several Board members, the City's outside counsel, City staff, the Board's outside counsel and others met to discuss aspects of the Searle increase. Mr. St. John, who participated in the meeting, took extensive notes and prepared a transcript. (AR 1591-1598B et seq.) City staff argued that debt service should not be indexed; the consultants replied that there is no "'typical'" debt service ratio, that "Partial indexing leads to ever-increasing expense ratios" and that "Owners cannot operate rental property with ever-increasing expense ratios." (AR 1592B.) Others expressed similar concerns. (AR 1593B.) The City's outside counsel urged the Board to consider debt service only in the IRA process, a suggestion the consultants rejected. (AR 1592B.) One participant noted that

owners would manipulate debt-equity ratios if the City's proposal were adopted. (AR 1593B.) The City's representatives argued against indexing since 1979 for subsequent purchasers, asserting that the purchase price presumably took the current rents into account. (AR 1594B.) In response, participants asked whether sellers would be reimbursed for "windfall losses," noted that distinguishing rents on the basis of date of purchase would lead to "similar rental units having differing rents" (AR 1594B); stated that under Berkeley's system, purchasers buy all the prior owner's entitlement and "Buying owners relied on the fact that the Ordinance promised a fair return." (AR 1594B.)

The consultants appeared at a special Board meeting that night. (AR 817B et seq.) The morning's meeting was discussed. (AR 832B.) The Board had created a Searle task force which had started meeting in July. (AR 581B.) Commissioner Olds stated that the task force was leaning toward 100 percent indexing for all properties which it believed would take care of 99 percent of the owners. (AR 819B.) She further indicated the task force **was trying to "stay away from a percentage on fair returns."** (AR 824B.) Mr. Sims stated that 100 percent indexing is designed to adjust for inflation "so that the purchasing power of NOI to the landlord is the is the same." (AR 825B.) Commissioner Olds noted that a suggestion had been made to index only from the date of purchase, but that proposal had been rejected. (AR 834B.) She stated that notwithstanding other suggestions, "The simplest fair return is you maintain your base year NOI at 100%." (AR 834B.) The consultants explained that indexing NOI, rather than rents, is favored because operating costs do not necessarily rise at the same rate as the CPI; local taxes, for instance, are not included in the CPI. (AR 834-835B.) In Berkeley, operating costs rose faster than the CPI. (AR 835-836B.) The consultants also confirmed that the first three years of AGA determinations were inaccurate. (AR 837B.)

Commissioner Noguera asked about properties that had been owned free and clear and those purchased recently. (AR 838B.) Hamilton responded that by "100% indexing of NOI . . . you avoid

the whole issue." (AR 838B.) Discussing buildings which had changed hands, Ms. Rabinowitz explained that regulators should not favor a particular method of financing. (AR 840B.)

The consultants reiterated the complexity of adopting a fair return system based on a particular rate of return. (AR 844B.) They noted that indexing and the fair return standard should be consistent. (AR 846B.) Mr. Hamilton noted that pegging fair return to another investment of comparable risk is difficult because different owners have different risks. (AR 848B.) The Board's counsel noted the difficulty of selecting a number and applying that number to cash investment. (AR 849B.)

Mr. Hamilton and the Board's attorney confirmed that 100 percent indexing was the simplest to administer and would be upheld by the courts. (AR 850-851B.) Hamilton reiterated HR&A analysis that indexing only a portion of NOI, i.e. costs, would preclude NOI from keeping pace with inflation. (AR 856B.) The Board passed a motion to use 100 CPI less shelter as the Board's probable approach for fair return. (AR 833-834B, 852-854B.)

On August 19, 1991, the consultants delivered the final version of their report, Inflation Indexing in Berkeley Rent Regulation in the Aftermath of the Searle Decision. (AR 264-357B.) The report was essentially identical to the draft report delivered on July 30. (AR 92-185B.) It reiterated the recommendation of 100 percent indexing through the AGA process.

July - September, 1991: The Board Holds A Succession Of Public Meetings At Which It Hears From Interested Owners, Tenants And The City.

The Searle Task Force had several meetings from July 18 to August 29, 1991. (AR 73-74B, 581B, 888-890B.) On July 15, 1991, the Board held the first of several public sessions on the Searle increases, hearing from its consultants, owners and tenants.

After its August 16, 1991 meeting, the Board held further sessions on September 5, 1991 (AR 803--816B), September 10, 1991 (AR 748-802B), September 16, 1991 (AR 716-747B), September 21, 1991 (AR 407B, 683-690B); and September 26, 1991. (AR 613B et seq.)

Over 100 speakers addressed the Board at these meetings; their comments ran the policy spectrum.

Owners and their advocates noted the unfairness of requiring IRA petitions to obtain an inflation adjustment (AR 813-814B); noted the inability of owners to pay for repairs (AR 745-746B) and pointed to the deteriorating housing stock (AR 624B), blaming the situation on Berkeley's "virulent rent control" (645B). They also complained that the value of his rents approximated that of ten years before and the return of "minority landlords . . . is almost nil[]" (AR 816B); complained that tenants were being subsidized (AR 684B; AR 690B); complained that they had been waiting twelve years for a fair return on their investments (AR 792B); critiqued use of the CPI-less shelter index because owners must meet their own housing costs (AR 797-798B); and equated Berkeley's treatment of landlords "to the treatment of Blacks in the South." (AR 801B). They also noted that rents after the Searle increase would be the lowest in the Bay Area (AR 732B), if not any metropolitan area (AR 739-740B); complained that Berkeley unfairly "punishes" owners (AR 732-733B); praised the Board for finally creating incentives for owners to maintain and improve their properties, and noted the large loss of units available to students as a result of Berkeley's prior policies (AR 737-738B.)

Summing up the situation, the Board's former director observed that the Board, which had denied legitimate interests in the past, was compelled "to make up in one lump sum all the misery that it has put out over the years." (AR 742B.) A written argument contained many of these points. (AR 358B, 1015B.)

On September 10, 1991, Steve Barton spoke on behalf of the City Manager's office. He made three points: (1) the entirety of NOI should not be indexed because most of NOI goes to debt service; (2) NOI of properties purchased after 1979 should only be indexed from the purchase date because, "It should be presumed that at the time the purchase took place the new owner paid a price that gave him an acceptable rate of return and only that return should be

indexed"; and past AGAs were too high. (AR 793B.)¹³

Tenants and their advocates also addressed the Board. A tenant advocate restated the points raised by Steve Barton, arguing that the Board should not index debt service; said owners should get increases only from the purchase date and maintained the AGAs were too high. (AR 717B, 728-729B.) Advocates reiterated that Searle II gave the Board great discretion. (AR 728B, 734-735B.) Other tenants warned of the windfall owners would reap, termed the Board's proposals a "sham" and an "outrage"); argued that the increases would destroy the quality of life in Berkeley by destroying the middle class for the benefit of large landlords; urged the Board to maintain Berkeley's diversity; and noted the effect of the increase on seniors (AR 683B, 686-687B, 730-732B, 733-734B, 735-736B, 741B, 743-744B, 746-747B.)

The Board Hears Specific Comments On Indexing Inflation From The Base Year For Properties Purchased Since 1979: Owners Explain That Indexing Of These Properties From The Base Year Is Consistent With The Existing MNOI System On Which Owners And Investors Have Long-Relied.

Steve Barton had urged the Board not to index properties purchased since 1979 from the base year. The consultants had rejected that idea. The Board also heard from owners and their advocates on this issue.

In July , 1991, property owner Kurt Schoeneman submitted a

¹³ On July 5, 1991 Barton advised the Council's Housing Subcommittee that the Board had established certified rents for 1980, but had not certified rents for 1979. He further stated:

Previous research involving Rent Program files suggests that data on 1978 and 1979 rents is quite incomplete and that there was extensive landlord non-cooperation prior to 1980. ¶ Increases can not be justified for 1979-80 without evidence of compliance with rent control during that time period and should be based on examination of individual property records. It would no doubt be costly to hire staff to examine the files for all properties during this time period, but it would be even more costly for tenants not to do so.

(AR 1006B.)

statement to the Board supporting the indexing of inflation from the inception of rent control and not simply from the date of purchase by the current owner. (AR 998-999B.) He explained that purchasers of rental property often, if not always, assumed that the Board would eventually index for inflation. Moreover, the Board had never differentiated between current and previous owners:

In fact, in the entire time of Berkeley's rent control, no such distinction between the original owner and a later acquiring owner has been made. Capital improvements done by a previous owner can be passed through by an acquiring owner. The former inflation index of 40% of the CPI never distinguished between original and subsequent owners. In fact, the theory has been that an acquiring owner gets all the benefits and, just as importantly, all the liabilities, of the former owner.

(AR 998B.) He had paid a purchase price based on his expectation that rents would eventually be adjusted for inflation. (AR 999B.) One owner argued that all properties had suffered and so all should obtain the increase, regardless of when acquired. (AR 725B.)

Owners told the Board to allow Searle increases for post 1979 purchasers, stating that owners had invested with the justified expectation that rent control would moderate (AR 645B), the Board would follow Fisher and index for inflation. (AR 621-622B).

Economist Michael St. John explained that under Berkeley's system, subsequent owners purchased the prior owner's entitlements and liabilities:

The logic of the Searle decision is that properties require full indexing from 1979 forward if they're to remain financially viable as rental property. . . . No one has ever suggested that the annual adjustments should be allowed for the duration of an owner's ownership only. Similarly, it does not make sense that indexing should be limited to the duration of time that an owner has owned a property. . . . New owners buy all entitlement as well as all liabilities with the property when they purchased it. If the former owner, for example, failed to pay his Rent Board fees, the new owner would have to pay them. If the old owner let the property run down, the new owner would have more work to do. If an old owner did capital improvements, the new owner is entitled to the rent increases following from those capital

improvements. If the old owner, in the pre-Searle environment, didn't receive indexing benefits, the new owner in the post-Searle environment does deserve those indexing benefits. He bought them along with the property. In buying the property, the new owner bought the entitlement to full indexing just the way he buys the entitlement to reimbursement for capital improvements done by the former owner. The Hamilton, Rabinowitz report on fair return clearly identifies full indexing from 1978 forward as a key ingredient in a rational, fair return standard. Partial indexing is confiscatory, unconstitutional and denies a fair return.

(AR 631-632B.)

In response, one tenant accused the Board of rewarding speculators who "bought on the expectation that a Board such as this one would take an action such as this one." (AR 683B.)

The Board Debates The Proposed Regulations: It Adopts The Consultants' Recommendations, Maintaining The MNOI System For All Properties While Phasing-In The Increases To Assist Low Income Tenants.

Starting with its meeting on September 10, 1991, the Board debated three Searle regulations over the course of several meetings. (E.g., AR 212B, 220B, 362-363B, 403B, 649-672B, 693-715B;; 748-790B.) Regulation 1100 was the pre-existing umbrella AGA regulation which the Board would amend to include an inflation covering the entire NOI in the annual adjustment. Regulation 1113 covered the one-time inflation adjustment to account for inflation from 1979-1990. Regulation 1274 would be amended to phase-in the increases.

During the Board's debate, Chair David Bryden emphasized the Board's concerning with maintaining the housing stock:

We've been looking hard at reforms that protect those legitimate interests. To keep people in their homes. We want to keep people in their homes two ways. By having rents that they can afford. But we also want to have housing available for them and we do believe that a great number of Berkeley citizens have been displaced in this City because of a lack of affordable housing that have been created by a situation where we have rent control that tends to put the rental industry out of business.

(AR 748B.)

He further stated that the Board had entered the process with an open mind and was following the consultants' recommendations, including those adverse to owners:

I want to remind you that the Searle decision's own language said, yes it's possibly conceivable to have something less than 100% but . . . from a legal standpoint that if this Board took the easy route that time, we could have said 100% CPI and passed that regulation months ago. And the court would have been happy . . . and it would have been real easy. But this Board consciously took the course designed to maximize the protections . . . tenants and engaged the study to come up with a rational basis. We did indeed yield fruit for tenants because we're proposing to you tonight that we don't pay 100% of the full CPI but that we use 100% of the CPI less shelter and that results in an immediate 4% less increase for tenants and it will amount to lower increases into the future. We could have gone with 100% full CPI but we didn't. We spent \$60,000 and hired what we considered to be the best economic consulting firm in the nation for this kind of economic analysis.

(AR 696-697B.) Commissioner Migdal noted that the Board did not control the consultants or tell them what to recommend. (AR 698B.)

The Board adopted amended Regulation 1100 at second reading on September 16, 1991: It states in relevant part:

(A) The annual general adjustment shall include an adjustment to protect landlords' net operating income from the adverse effects of inflation. . . . The annual general adjustment amount appropriate to protect net operating income from inflation shall be determined by multiplying 100% of the percentage increase in the specified consumer price index by a percentage of rents which net operating income is estimated to equal for controlled units in general.

(AR 403B.)

Preparatory to the adoption of Regulation 1113, the 1991 Inflation Adjustment Order, the consultants submitted two charts which calculated the Searle adjustment. The 1979 NOI ratio was .60 and that the CPI less shelter had increased 75 percent from 1979 to 1990. Multiplying that 1979 NOI ratio by the increase in the CPI resulted in a Searle NOI adjustment of 45 percent of the May 31,

1980 rents. (AR 385Ba.) The Board incorporated that calculation in Regulation 1113, the 1991 inflation adjustment order, effective November 1, 1991. (AR 506-507B, 702B.)

Commissioner Olds noted that the consultants had advised the Board "that anything less than 100% would not be a fair return to the property owners." (AR 693B.) Commissioner Migdal noted that as of September, 1991, Berkeley's median rent was the lowest among 125 Bay Area communities; after the proposed Searle increases, Berkeley's rents would be the seventh lowest, surpassing only Rio Vista, Cloverdale, Monte Rio, Crockett, Rodeo and perhaps, Dixon. (AR 704-705B.) Cotati, East Palo Alto, Oakland and Richmond would have higher rents. (AR 705B.) The Board adopted Regulation 1113 at second reading on September 26, 1991. (AR 649-658B.)

Amended Regulation 1274C addressed the phase-in of the increases. Although, as Chair Bryden noted, Searle II had not required "special protections for low income tenants[,]" (AR 709B), the Board phased-in the increases. Regulation 1274(C) limited Searle increases for low income tenants to the greater of ten percent of the prior year's rent or thirty percent of the household's annual gross income. (AR 710B; 712-713B.) ¹⁴ The regulation was adopted on September 26, 1991. (AR 658-666B.)

September, 1993: The Consultants' Final Draft Report On Fair Return: It Rejects The Literal Rate Of Return On Investment Standard And Recommends That The Board Have Only One Fair Return Standard -- 100 Percent Inflation Indexing Of Fair Base Year NOI.

On September 16, 1991, the Board passed amended Regulation 1100 at second reading

On September 23, 1991, the consultants submitted their Final Review Draft of their study, "Defining 'Fair Rate Of Return' In

¹⁴ As amended, the regulation permitted only one Searle increase for low-income tenants during the November 1, 1991 - December 31, 1992 period. (AR 517B, 664-665B.) The Board also prepared a mailing explaining the Searle increase to tenants. (AR 671-672B.) The Board later amended Regulations 1113 and 1274 in October to give low-income tenants more protection. (AR 563-580B.)

Berkeley Rent Regulation In The Aftermath Of The Searle Decision." (AR 443-501B.) After noting that "fair return" was a subjective concept which courts had failed to precisely define, (AR 440B, 448-450B), the consultants reviewed fair return standards of other ordinances. (AR 451-495B.) The report reiterated that "there is no technical justification for indexing NOI at any level below 100% of the change in the CPI if the intent of the indexing is to maintain the purchasing power of base-year NOI." (AR 463B.) 100 percent indexing through the AGAs was also highly practical: "The higher the level of CPI-U indexing a city allows in its AGA, the lower the probability that successful fair return petitions will be filed by property owners." (AR 465B.)

The consultants also discussed the MNOI and rate of return on investment return standards, noting the complexity of the latter approach. (AR 470B et seq.) Since the Board had already chosen 100 percent indexing, its remaining task was to ensure that its indexing and fair return rules were consistent:

On the conceptual side, consistency is assured by the fact that the inflation indexing principle is identical on the two fronts. This principle is that the proper annual indexing coefficient is 100% of the change in the regional CPI-U. The MBYNOI definition of fair return then adds the corollary that if base-year NOI has been determined to be fair, then properly indexed base-year NOI does represent a fair return on a landlord's investment.

The objective of providing a consistent financial outcome for property owners through both processes reinforces the Board's instruction to focus attention on an NOI-based fair return standard rather than its primary alternatives, which would seem to be any of these several standards based on rate of return on investment. Although the AGA indexing process could be made consistent with a standard of the latter variety, the risk of anomalous results would, in the consultants' opinion, be substantial.

Given the importance of maintaining consistency between the fair return standard implied in the AGA regulations and the explicit fair return definition employed in IRA fair return regulations, it is also clear that the preferred fair return standard would employ rent

adjustment regulations, language and procedures that are identical to those used to calculate AGAs. Deviations are likely to create inconsistent petition decisions. This is an additional reason to prefer the MBYNOI standard of fair return, which explicitly takes into account changes in operating expense, to a standard of fixed percentage return on investment.

(AR 496-498B.)

The consultants recommended identifying Regulation 1264 as the fair return standard and revising the NOI-indexing provision of Regulation 1264 from 40 percent to 100 percent indexing, using the same CPI index for both the IRA and AGA process. (AR 499-501B.)

The Board adopted a Resolution (91-31) setting forth the basis for its action. (AR 242-246B, draft); 362B; 785B; 7JA 134, at 2232.) The Resolution made several findings, including:

- * That the Board had been commanded to conform its regulations to the Searle decision

- * That the Board had hired HR&A, "a nationwide economics and public policy consulting group with wide experience in rent control";

- * That four public hearings had been held;

- * That the consultants had submitted a study;

- * That the consultants had advised the Board that "indexing net operating income at a rate less than 100% of the rate of inflation guarantees that the real value of net operating income will decline over time;"

- * That the consultants concluded that "it cannot reliably be assumed that any portion of net operating income is generally insulated from inflation because it is committed to pay debt service, and there is no practical way in making a general adjustment of rents to single out the portion of an individual landlord's income used to pay debt service";

- * Failure to adjust NOI at 100 percent of the rate of inflation "would over time reduce owners' ability to pay debt service, whatever the amounts or terms of their outstanding

loans";

* The consultants advised the Board that indexing debt service as a separate component of NOI "would lead landlords to tailor their debt structure to maximize rents, since a landlord has a wide choice of principal amounts, interest rates and terms of repayment.";

* "Maintaining net operating income against adverse effects from inflation allows debt and financing decisions to be made on a rational basis, without being systemically constrained by declining net operating income (not fully adjusted for inflation) or being manipulated to maximize regulated rents'"

* Protection against inflation will require one-time adjustment(s) of rent because NOI has not kept pace with inflation except to the extent rents were partially indexed in individual IRA petitions under Regulation 1264; such adjustment(s) is mandated by Searle.

* "[E]ffect of adjustment on low-income persons should be minimized;" adjustments will be phased-in for tenants whose rents exceed thirty percent of their income, permitting full adjustment to take effect over reasonable period of time.

(7JA 134, at 2232-2235.)

Taking the consultants' report and presentation, public testimony and submissions, its own experience and the requirement that rents be set at fair levels while taking inflation into account, the Board resolved to index rents at 100 percent of the rate of inflation. (7 App. 134 at 2235.)

The Consultants Submit Their Final Fair Return Report: They Recommend Adherence To The MNOI Standard; The Board Agrees And Adopts Regulation 1264 Setting Forth The Board's Only Fair Standard -- Indexing NOI Of All Properties At 100 Percent From The Base Year.

In December, 1991, the consultants submitted their final Fair Return report, which but for an additional discussion of debt service and comparable rents, was virtually identical to the final draft report. It recommended that 100 percent indexing from the

base year should be the Board's only fair return standard. Effective March 20, 1992, the Board adopted amended Regulation 1264 and repealed Regulation 1275, the Board's prior fair return regulation. In relevant part, Regulation 1264 stated:

(A) The landlord is entitled to a fair return. Ordinarily, a fair return will be measured by maintaining the net operating income produced by the property in the base year, adjusted by 100% of the percentage increase in the Consumer Price Index (CPI) . . . less its shelter component . . . since June 1979, if 1979 is the base year.

On May 19, 1992, the Board filed its "Further Return to Peremptory Writ of Mandate." (7JA 140 at 2380.) The Board cited HR&A's December, 1991 report and attached all regulations adopted pursuant to Searle II, including Reg. 1264. (7JA 140 at 2402.)

1992: Berkeley Voters Reject Initiative Measures Which Limit Searle Increases To Nine Percent.

In June, 1992, Berkeley voters rejected a ballot initiative (Measure E) which sought to rescind the Searle regulations and limit increases to nine percent. In November, 1992, the voters rejected a virtually identical initiative (Measure H) and gave the moderate slate an eight-to-one majority.

1987-1991: The Board Strenuously Debates And Finally Adopts The Historically Low Rent Regulation (Regulation 1280.)

Historically Low Rents (HLRs) refer to a large group of properties, many owned by minority owners, which were below market on the eve of rent control and remained particularly low during the ensuing decade.

In the summer of 1987, the Black Property Owners Association proposed that an accelerated petition process be implemented allowing for the automatic increase of historically low rents over six month intervals. (AR 176A.) The association's president wrote:

Those owners have suffered tremendously. They are locked into historically low rents.

As time goes by, their units become less and less profitable. The disparity between their rents and other's grows larger and larger. These owners cannot maintain their properties. They cannot sell their properties. They cannot convert the properties to another use Truly, this group of owners represents Rent Control's Indentured Servants.

(AR 178-179A.) [Emph. in original.]

The Board studied the problem for four years before passing the HLR regulation. The Board's IRA committee discussed historically low rents on July 28, 1987. (AR 180A). On September 8, 1987, the Board hired consultant Kenneth Baar to study the issue. (AR 195A). In May, 1988, the Board retained Bay Area Economics (BAE) to study historically low rents. (AR 211-212A).

BAE's initial findings were presented on November 4, 1988. (AR 298-327A). The consultants also obtained views of owners about the Board's handling of IRA petitions; owners found the process cumbersome, time-consuming and unfair. (AR 313A). BAE submitted its final report on January 4, 1989. (AR 340A).

On September 26, 1989, Executive Director Brooks submitted a detailed report discussing HLRs. (AR 503A.) The report included charts listing the number of units between 50 and 100 percent of area and city-wide medians.

In the following months Board members advanced competing HLR proposals. Some focused on properties with rents falling in a range between 60 and 80% of city wide medians, while another urged relief for all properties below 100% of the median. (AR 531A.)

Commissioners Watts, Bryden, DeVries and Olds also submitted a report. (AR 582-586A.) It noted that the low rents coupled with high expenses and taxes had led to "rapid deterioration and 'ghettorization.'" (AR 585A.) Recognizing the "command" of the Ordinance that the Board "'set rents at fair and equitable levels in order to achieve the purposes of this chapter," the report concluded: "We urge the Board to set base rents based upon the rent or a percentage of the rent for comparable section 8 units on May 31, 1980." (AR 586A.)

On January 18, 1990, The Black Property Owners Association submitted a strongly worded letter to the Board supporting relief for properties with HLRs. (AR 589A.)

On January 18, 1990, the Board voted to request information from the staff "of different rent levels to be at different percentages of the HUD Section 8 rents . . . in 1980." (AR 591A.)

On February 5, 1990, Commissioners, Bryden, DeVries, Olds and Watts proposed to define historically low rents as those 1980 base rents which fell below the City-wide median rent level as found in the BAE study. (AR 592A, 596A, 599A.) The following week Commissioner Noguera submitted his proposal (AR 611-617A.) The public also submitted written comments to the Board. (AR 601-604A; 618-628A.) The Board held a public hearing on HLRs on February 22, 1990 at which it heard 47 speakers. (AR 629A.) Public hearings were also held on March 15 and April 18, 1990. (AR 635A.)

In late June and early July, 1990 three commissioners submitted additional proposals. (AR 638A-643A; 645-648A.)

Frustrated by the Board's inaction, the Black Property Owners Association placed a measure on the November 1990 Berkeley ballot to amend the ordinance by setting a minimum rent of 65% of the current HUD rent levels. The measure was narrowly defeated, 21,711 to 20,520. (5JA 81, at 1687.)

On February 13, 1991 the Board's IRA committee passed a proposed HLR regulation, Regulation 1280 (AR 651A), which the Board discussed at its meeting held of February 21, 1991. Commissioner Migdal favored minimum rent levels "significantly below Measure E" as well as a phase-in period and hardship exemptions. (AR 656A.) Commissioner Watts argued that 75% was too low, (AR 660A), while Commissioner Marsh favored tying the minimum rents to the median rents as suggested by the consultants. (AR 662A.)

The Board also heard twenty-two speakers on the issue at the public forum which preceded other business. (AR 664-695A, 696A.) The staff was requested to prepare Regulation 1280 for first reading scheduled for March 18, 1991. (AR 699-701A.) Following comments by numerous public speakers (AR 717-735A), the Board

debated the regulation, which was passed at first reading by an 8-1 vote. (AR 751-752A, 764A.) As initially passed, Regulation 1280 provided for automatic adjustment of 1979 rents falling below 75% of the rents established by HUD in that year. (AR 756-757A.) After discussing the matter at subsequent meetings (AR 816-830A.)

On May 23, 1991 the Board held yet another public hearing on Regulation 1280. (AR 894-914A.) After an extended discussion on the regulation, the Board made several amendments and enacted it by a 7-1 vote. (AR 938-939A, 941-942A.)

As enacted, Regulation 1280 defined units with historically low rents as those with (1) 1979 rents below 75 percent of the 1979 HUD rents (AR 975A) and (2) with 1991 rents less than the sum of the 1979 minimum rents plus the intervening AGAs. (AR 966-967A.) The 1979 minimum rents were as follows: Studio, \$163; one bedroom, \$198; 2 bedroom, \$233; 3 bedroom, 323; and 4 bedroom, \$353. Those rents were lower than the mean 1980 certified rents as calculated in the December, 1988 BAE study (AR 1635B) and below the city-wide 1980 median rents calculated by the Board. (AR 550A.)¹⁵

The nearly unanimous voted reflected the broad consensus in favor of adjusting historically low rents. Commissioner Noguera, aligned with the faction favoring strict rent control, noted that Berkeley rents would still remain much lower than rents in neighboring communities. (AR 928-929A)

The findings in Regulation 1280 stated:

The purpose of this regulation is to provide prompt and fair adjustments of rents which are well below typical levels because they were significantly below market levels at the inception of rent controls.

Information included in a comprehensive study of the issue, testimony at a series of public hearings, information contained in Rent Board records, experience in other matters before the Board and materials submitted

¹⁵ Even when the median and mean 1980 rents are reduced by five percent on the assumption that owners took the five percent 1980 increase permitted in limited situation by Ordinance 5212, the mean and median rents still fall below the HLR minimums.

to the Board show that many units in Berkeley had rents in 1979 and 1980 which were significantly below market rents for comparable units. Because current rent levels and the ability to receive a fair return under the rent ordinance depend on rents at the outset of rent control, it is appropriate to adjust rents for units which had below-market rents at that time. The information before the Board shows that those Berkeley units which were rented at market in 1979 had rents at or above 75% of the HUD fair market rent for Alameda County; rents below that level were not at market.

(AR 964A; 7 App. 140 at p. 2396.)

In the summer and fall of 1991 the Board discussed the impact of the Searle increases on the HLR adjustments. (AR 755-764B, 821B.) After a full debate, the Board decided to apply the Searle multiplier to the actual 1980 base rent as it did for non-HLR units and add the result of that calculation relevant 1991 HLR rent included in the table in Regulation 1280. (AR 362B, 763-764B.)

On September 16, 1991 Revised Regulation 1280 was passed at first reading. (AR 403B, 714-715B.) On September 26, 1991, the Board adopted the regulation. (AR 665-666B.) The current regulations reflect slight amendments effective March, 1992.

An Appellate Court Decision Leads The Board To Amend the Comparable Base Rent Regulation (Regulation 1262(C)(3)).

Berkeley's rent control ordinance rested on the presumption that owners were charging market rents on the eve of rent control and those "base rents" would serve as the starting point for any subsequent adjustments. In Birkenfeld v. City of Berkeley (1976) 17 Cal.3d 129, the Supreme Court had addressed the issue of adjusting the base rents of units with below market base rents.

It is clear that if the base rent for all controlled units were to remain as the maximum rent for an indefinite period many or most rent ceilings would be or become confiscatory. For such rent ceilings of indefinite duration an adjustment method is necessary to provide for changes in circumstances and also provide for the previously mentioned situations in which the base rent cannot reasonably be deemed to reflect general market conditions.

(17 Cal.3d at 169.)¹⁶

Regulation 1262 adopted in 1981 permitted adjustment of the base rent if a special relationship existed between the landlord or tenant (Reg. 1262(C)(1); if the landlord's operating expenses in the base year were exceptionally high or low (Reg. 1262(C)(2); or as a result of "other factors which would cause the application of the base year net operating income to result in gross inequity to either the landlord or the tenant." (Reg. 1262(c)(3.))

In 1987, however, the Board deleted the "other factors" in 1262(C)(3.) The revised 1262(C) permitted adjustments when the landlord's operating and maintenance expenses were "unusually high or low in comparison to other years" (Reg. 1262(C)(a)) or the base rent "was not established in an arms-length transaction or was otherwise not set under market conditions." (Reg. 1262(C)(b).)

In 1990, the Court of Appeal squarely addressed the issue of adjusting base rents to reflect prevailing pre-rent control market conditions. (Vega v. City of West Hollywood (1990) 223 Cal.App.3d 1342.) Relying on Birkenfeld, the Court stated:

Birkenfeld also discussed two other ways in which the administrative mechanism for establishing rent ceilings could operate improperly and run afoul of constitutional constraints. Rent ceilings of an indefinite duration would be confiscatory and thus unconstitutional if no

¹⁶ The Court's reference to "previously mentioned situations in which the base rent cannot reasonably be deemed to reflect general market conditions" alluded to the Birkenfeld plaintiff's criticism of Berkeley's charter amendment due to its "omission of factors that might have prevented the base rent from reflecting general market conditions such as a seasonal fluctuation in the demand for the kind of housing involved or the existence of a special relationship between landlord and tenant resulting in an undercharging of rent." (17 Cal.3d at 168.)

adjustment mechanism existed . . . (2) to provide, as relevant to the ordinance under review, for "situations in which the base rent cannot reasonably be deemed to reflect general market conditions." (citation omitted) ¶ ... When base date rents can be adjusted to reflect prevailing rents for comparable units, everyone within the ambit of the rent control scheme participates on an equal footing.

* * *

Most significantly, the critical questions are not whether the base date rents establish a "fair and reasonable" return and whether the base date rents, even if low, are "within" a range of rents which can be charged." [citation omitted]. Rather, the question is whether the base date rents can "reasonably be deemed to reflect general market conditions." (Birkenfeld v. City of Berkeley, supra, 17 Cal.3d at p.169.) After base date rents are established which reflect general market conditions, then the Commission should apply and maintain the net operating income formula of the ordinance. . . . ¶ . . . [A] property owner must be permitted, pursuant to the principles discussed in Birkenfeld v. City of Berkeley, supra, 17 Cal.3d 129, to start rent calculations with a base date rent similar to other comparable properties.

223 Cal.App.3d at 1349, 1351-1352. [emphasis added.]

On February 21, 1991, the Board voted to amend Regulation 1262 to conform to Vega. (AR 133-135A, 140A.) On March 18, 1991, the Board heard the first reading of the proposed amendment which added a further ground for adjusting base year rents:

(3) The base year rent was below prevailing market rents for comparable units in the base year. Comparability of units shall be judged based on the number of bedrooms, neighborhood, and services and amenities provided.

(AR 148A.) The amendment passed at first reading by a vote of 7-2. (AR 149-152A, 155A.)

On April 15, 1991, the Board's counsel, Richard Judd, submitted a legal opinion on proposed Regulation 1262. (AR 16-162A.) He first stated that the proposed amendment was within the Board's authority under California case law and the Ordinance. (AR 160A.) He noted that Berkeley had long adopted the maintenance of base year net operating income as its fair return standard, the same standard used in West Hollywood. (AR 161A.) He concluded that "So long as the City properly uses a net operating income

standard to implement the Ordinance's fair return provisions, the principles of Vega not only permit but appear to require adjustments for unusually low base rents". (AR 162A.) That day the Board adopted the amendment by a vote of 5-2. (AR 163-166A.)

In December, 1991, HR&A submitted the final report on Fair Return. They advised the Board to include a provision such as amended 1262(c)(3) in its regulations to ensure that owners received a fair return under the MNOI fair return standard set forth in amended Regulation 1264. The Board has made amendments as recently as February, 1993 to Regulation 1262.

STANDARD OF REVIEW

In deciding whether to uphold the regulations before it, the appropriate question here is whether the Board, acting within its delegated authority, acted reasonably or arbitrarily. The wisdom of the Board's actions is not at issue.

The Board adopted its regulations at the end of a lengthy and arduous rule-making process. The administrative record consumes several thousand pages recording a multitude of experts' reports; public forums, public hearings and legal opinions. Moreover, the Board acted after a decade of prior regulations which had created a particular "fair return" system on which owners and tenants and investors had long relied -- the Maintenance of Base Year Net Operating Income standard, (the "MNOI" or "MBYNOI" standard). That standard disregards changes in ownership and purchase price. The Board also acted in response to this Court's opinion in Searle II and the decision in Vega v. City of West Hollywood (1990) 223 Cal.App.3d 1342. In light of this extensive record, this Court's analysis must be guided by the following interrelated principles governing judicial review of the Board's quasi-legislative action:

In a mandamus proceeding, the ultimate question, whether the agency's action was arbitrary or capricious, is a question of law. Trial and appellate courts therefore perform the same function and the trial court's statement of decision has no conclusive effect.

(Shappell Industries, Inc. v. Governing Board of the Milipitas

Unified School District (1991) 1 Cal.App.4th 218, 233; e.g., California State Automobile Assn. Inter-Insurance Bureau v. Garamendi (1992) 6 Cal.App.4th 1409, 1418; Lewin v. St. Joseph Hospital of Orange (1978) 82 Cal.App.3d 368, 386-387.

A reviewing court will ask three questions: first, did the agency act within the scope of its delegated authority; second, did the agency employ fair procedures; and third, was the agency action reasonable.

(California Hotel & Motel Assn. v. Industrial Welfare Commission (1979) 25 Cal.3d 200, 212-213; e.g., Western Oil & Gas Assn v. Air Resources Board (1984) 37 Cal.3d 502, 509-510; Ralph's Grocery Store v. Reimel (1968) 69 Cal.2d 172, 175, n.2. (citing 1 Davis, Administrative Law Treatise (1958) sec. 5.05); Garamendi, 6 Cal.App.4th at 1422.)

In determining whether a specific administrative rule falls within the coverage of the delegated power, the sole function of this court is to decide whether the department reasonably interpreted the legislative mandate.

(Credit Insurance General Agents Ass'n v. Payne (1976) 16 Cal.3d 651, 656-657; Rible v. Hughes (1944) 24 Cal.2d 437, 445; Benton v. Board of Supervisors of Napa County (1991) 226 Cal.App.3d 1467, 1479; Physicians and Surgeons Laboratories, Inc. v. Department of Health Services (1992) 6 Cal.App.4th 968, 982.)

Courts have long recognized that the Legislature may elect to defer to and rely upon the expertise of administrative agencies.

(Payne, 16 Cal.3d at 656-657; Ralph's Grocery, 69 Cal.2d at 176; Pitts v. Perluss (1962) 58 Cal.2d 824, 832, 835 ("The rendition of this regulation involved 'highly technical matters requiring the assistance of skilled and trained experts and economists and the gathering and study of large amounts of statistical data and information.'"); Ray v. Parker (1940) 15 Cal.2d 275, 311; Garrick Development Company v. Hayward Unified School District (1992) 3 Cal.App.4th 320, 328; Shappell Industries, Inc., 1 Cal.App.4th at 230; Golden Cheese Co. of California v. Voss (1991) 230 Cal.App.3d

547, 556 ("The establishment of minimum prices involves highly technical matters requiring the assistance of skilled and trained experts and economists and the gathering and study of large amounts of statistical information."); Fendrich v. Van De Kamp (1986) 182 Cal.App.3d 246, 262; Young v. California State Board of Control (1979) 93 Cal.App.3d 637, 640-641.)

Courts should let administrative boards and officers work out their problems with as little judicial interference as possible.

Perluss, 58 Cal.2d at 835; Nelson v. Dean, (1946) 27 Cal.2d 873, 881; Cole v. City of Oakland Residential Rent Arbitration Board (1992) 3 Cal.App.4th 693, 700 (rent control case in which tenants contended board regulation effected a windfall); Stauffer Chemical Co. v. California State Air Resources Board (1982) 128 Cal.App.3d 789, 795 ("In technical matters requiring the assistance of experts and the study of marshalled scientific data as reflected herein, courts will permit administrative agencies to work out their problems with as little judicial interference as possible."); Brock v. Superior Court (1952) 109 Cal.App.2d 594, 604.)

[I]t is well-settled in this state that [administrative] officials may exercise such additional powers as are necessary for the due and efficient administration of powers expressly granted by statute, or as may fairly be implied from the statute granting the powers.

(Calfarm Insurance Co. v. Deukmejian (1989) 48 Cal.3d 805, at 824-825; Agricultural Labor Relations Bd. v. Superior Court (1976) 16 Cal.3d 392, 413; ("in discharging its delegated responsibilities the choice between proceeding by general rule or by ad hoc adjudication lies primarily in the informed discretion of the administrative agency."); Dean, 27 Cal.2d at 881; ("The Legislature may, after declaring a policy and fixing a primary standard, confer upon executive or administrative officers the 'power to fill up the details' by prescribing administrative rules and regulations to promote the purpose of the legislation and carry it into effect."); Ralph's Grocery, 69 Cal.2d at 176 & n.3; Garamendi (1992) 6

Cal.App.4th 1409, 1420-1421.)

The Agency is the entity charged with the administration of the Act. Its construction of [the act] is therefore entitled to great weight.

(United Outdoor Advertising Co. v. Business, Transportation and Housing Agency (1988) 44 Cal.3d 242, 246; Wilkinson v. Workers' Comp. Appeals Board (1977) 19 Cal.3d 491, 501; Rivera v. City of Fresno (1971) 6 Cal.3d 132, 140; Dean, 27 Cal.2d at 880-881; Cole, 3 Cal.App.4th at 698.)

When an administrative standing is of longstanding and has remained uniform, it is likely that numerous transactions have been entered into in reliance thereon, and it could be invalidated only at the cost of major readjustments and extensive litigation.

(Dean 27 Cal.2d, at 880-881; Anderson v. San Francisco Rent Stabilization and Arbitration Board (1987) 192 Cal.App.3d 1336, 1343; City of Santa Ana v. City of Garden Grove (1979) 100 Cal.App.3d 521, 530.)

As to the quasi-legislative acts of administrative agencies, judicial review is limited to an examination of the proceedings before the officer to determine whether his action has been arbitrary, capricious, or entirely lacking in evidentiary support, or whether he has failed to follow the procedure and give the notices required by law.

(Perluss, 58 Cal.2d at 833; e.g.; IBM v. State Board of Equalization, (1980) 26 Cal.3d 923, 930-931 & n.7 [standard applies to review of rule-making, citing Davis, Administrative Law Treatise (2d ed. 1980 pocket supp.) § 29.01-1.]; California Hotel & Motel Assn., 25 Cal.3d at 212-213; Garrick Development Co., 3 Cal.App.4th at 328; Physicians and Surgeons Laboratories, 6 Cal.App.4th at 982; Shappell Industries, Inc., 1 Cal.App.4th 218, 230; Voss, 230 Cal.App.3d at 556; Mateo-Woodburn v. Fresno Community Hospital (1990) 221 Cal.App.3d 1169, 1183; Stoneham v. Rushen (1984) 156 Cal.App.3d 302, 308; Stauffer Chemical Co., 128 Cal.App.3d at 794; Lewin, 82 Cal.App.3d at 386-387.)

The courts have nothing to do with the wisdom or expediency of the measures adopted by an administrative agency to which the formulation and execution of state policy have been entrusted, and will not substitute their judgment or notions of expediency, reasonableness, or wisdom for those which have guided the agency.

(Faulkner v. California Toll Bridge Authority (1953) 40 Cal.2d 317; 329; e.g., Western Oil & Gas Assn., 37 Cal.3d 502, 509-510; Ralph's Grocery Store, 69 Cal.2d 172, 179-180; Perluss 58 Cal.2d at 835; Garamendi, 6 Cal.App.4th at 1422; Morgan v. Community Development Agency (1991) 231 Cal.App.3d 243, 257; Fendrich 182 Cal.App.3d at 262; Young v. California State Board of Control (1979) 93 Cal.App.3d 637, 640-641; Brock v. Superior Court (1952) 109 Cal.App.2d 594, 604.)

Mandamus will not lie to control an exercise of discretion, i.e. to compel an official to exercise discretion in a particular manner. . . . [A]lthough a court may order a local legislative body to perform a nondiscretionary ministerial act, it may not control a local board's discretion.

(Common Cause of California v. Board of Supervisors of Los Angeles County (1989) 49 Cal.3d 432, 442-443, 445; Garamendi 6 Cal.App.4th at 1423.)

In sum, courts defer to the agency's efforts when reviewing the product of quasi-legislative rule-making. That deference is heightened when, as here, the regulations are the product of arduous effort by a conscientious Board. California Hotel & Motel Assn., 25 Cal.3d 200, 212-213 & n.30. While a rule affecting individual rights will draw more exacting scrutiny, in the case of other regulations "courts will tend to defer to the presumed expertise of the agency acting within its scope of authority." Shappell Industries, Inc., 1 Cal.App.4th 218, 232.

There are also evidentiary rules governing review of quasi-legislative agency action. "[T]he determination whether the decision was arbitrary, capricious or entirely lacking in evidentiary support must be based on the 'evidence' considered by the administrative agency." Shappell Industries, Inc., 1 Cal.App.4th at 233-234. Producing new evidence at trial beyond

that contained in the record is, therefore, improper; conversely, failure to raise an issue at the public hearing waives the right to litigate that issue in court. Morgan, 231 Cal.App.3d at 258-259. The Board's action may be premised on matter adduced at the public hearing and its own files (Dominey v. Dept. of Personnel Administration (1988) 205 Cal.App.3d 729, 731-732, 738, n.6.) It may choose from different experts or rely on its own staff's studies which are a permissible basis for its decisions. Browning-Ferris Industries v. San Jose (1986) 181 Cal.App.3d 852.

ARGUMENT

I. THE TRIAL COURT ERRED BY FAILING TO PERCEIVE THAT THE BOARD'S REGULATIONS WHICH TIED RENT ADJUSTMENTS TO THE BASE YEAR AND IGNORED CHANGES IN OWNERSHIP AND THE PURCHASE PRICE WERE PERFECTLY CONSISTENT WITH THE MNOI SYSTEM WHICH THE BOARD HAD ADOPTED IN 1981 AND THE CONSULTANTS HAD ENDORSED.

A. The Trial Court Premised Its Decision On Two Incorrect Assumptions: (1) That Berkeley Had Adopted A Literal Rate Of Return On Investment Standard And (2) That Those Investing In Berkeley Rental Property Relied Solely On The Property's NOI On The Date Of Sale.

The trial court fundamentally erred by only allowing inflation adjustments from the date of purchase for properties purchased after 1979.¹⁷ These errors resulted from the faulty prism through which it analyzed the Board's actions. The court erroneously assumed that Berkeley was limited to a particular fair return model -- one which focused on an owner's investment in the property and the percentage rate of return the owner realized from that investment on the date of purchase. Testing the regulations within that specific model, the trial court assumed that post-rent control purchasers had paid a price adequate to provide sufficient **current** income to earn a fair return and had not factored any expectation

¹⁷ Because this Court reviews the regulations de novo, the trial court's decision should have no effect on this Court's decision. The question on appeal is whether the Board acted reasonably in adopting the regulations. Nonetheless, because the trial court adopted the City's arguments, the trial court's analysis serves as a practical starting point for discussing that aspect of the regulations overturned below.

of a future inflation adjustment into the purchase price. The court overlooked Berkeley's choice of a fair return on investment system -- the MNOI model -- on which tenants, owners, the Board and investors had long relied. The court also overlooked substantial evidence in the administrative record attesting to the wisdom and simplicity of the MNOI system, the many defects associated with the rate of return on investment model and the Board's consideration of and rejection of a proposal to classify properties purchased after 1979 differently from those purchased prior to rent control.

Believing Berkeley could only employ the rate of return on investment model, the court held that under that specific system, no justification existed for permitting owners who **presumably** paid a price calculated to earn a fair return on their investments at the time of purchase to obtain a greater return based on an inflation or comparable rent adjustment calculated from 1979. In deciding adjustments were "unwarranted," the court was making a choice not about economics, but about housing policy, a **policy choice** which only the Board was authorized to decide.

1. **The Trial Court Erroneously Assumed That The Board Was Compelled To Employ A Particular Kind Of Return On Investment System; In Doing So It Undermined The Board's Unified Fair Return System Recommended By The Consultants.**

As we have explained, in 1981, Berkeley opted for the MNOI system, which was **property specific** and stabilized rents by allowing them to increase only to cover increased operating expenses or capital improvements. The regulations did not allow rent increases as a result of changes in ownership, increased cash investment or added debt service. What an owner did again with the NOI -- the money remaining from gross rents after operating and maintenance expenses were deducted -- was of no concern to the Board under the MNOI system. An owner's "percentage rate of return on investment" was also irrelevant to the regulatory scheme.

Indeed, the Board's prior indexing regulation (Regulation 1264), which Searle II overturned, did not deny inflation

adjustments from the base year for properties purchase after 1980.

Nonetheless, this trial court assumed that the Board was constrained to adopt a particular rate of return model.¹⁸ Fisher, of course, had said otherwise, explaining that the Constitution did not compel the Board to implement a particular fair return system. (37 Cal.3d at 680; e.g., Cole, 3 Cal.App.4th at 700.) Both Cotati and Santa Monica, with ordinances assuring owners a fair return on investment, had implemented MNOI models to meet that obligation. (See, Baker v. City of Santa Monica (1986) 181 Cal.App.3d 972, 988 (MNOI system "essentially a return on investment standard.))

The court overlooked more than the Board's regulatory history. Without acknowledging its existence, the trial court's order contradicts the Board's new fair return regulation, amended Regulation 1264, adopted to carry out this Court's mandate as recommended by the consultants. The consultants emphasized "the importance of maintaining consistency" between the IRA and AGA fair return standards (AR 498B) and explained that "if base-year NOI has been determined to be fair, then properly indexed base-year NOI does represent a fair return on a landlord's investment." (AR 496B.) They advised the Board to incorporate the fair return standard in amended Regulation 1264. (AR 498-500B.) The Board therefore repealed Regulation 1275 and amended Regulation 1264 which states in relevant part:

(A) The landlord is entitled to a fair return. Ordinarily, a fair return will be measured by maintaining the net operating income produced by the property in the base year, adjusted by 100% of the percentage increase in the Consumer Price Index (CPI) . . . less its shelter component . . . since June 1979, if 1979 is the base year.

(7JA 140, at 2380, 2402.)

In deciding to adopt one unified fair return system in current

¹⁸ The City's counsel relied on the terms of the ordinance in arguing that Berkeley, unlike Cotati, did **not** have an NOI system ("Net operating income is not even in the Berkeley ordinance." (RT 5/26, at 102.))

Regulation 1264, the Board rejected the system ordered by the court. As Commissioner Olds noted, "we're trying to say away from a percentage on fair returns," noting a report about problems befalling Insurance Commissioner Garamendi. (AR 824B.) Affirming the result below will create two contradictory fair return systems.

The MNOI standard satisfied the Board's mandate under Searle II to implement a fair return system. Neither Searle II, the Constitution, nor the Ordinance compelled the Board to adopt a particular fair return model.

2. The Trial Court Further Assumed That Investors Pay A Purchase Price Based Solely On The Rents Or NOI Generated By The Property At The Date Of Sale.

The court concluded, without any evidentiary support in the record, that investors deserve no greater return than their return on the date of purchase unless they can rebut the presumption that the rents do not generate a fair return on investment. (7JA 119, at 2161.) The City had advanced the same analysis:

"We should assume that Buyer [who purchased in 1985] paid a price for the building which was low enough for him to receive a profit which he considered to be a fair one (or else he would not have bought the building) - without the need to raise rents (as he knew that the Rent Ordinance restricted rent increases.)

(Memorandum in Support of Preliminary Injunction, 2JA 34, at 401.)

This assumption is flawed. First, it finds no basis in the record; it represents the trial court's and the City's own understanding of real estate economics. The purchase price may reflect numerous factors, including financing options, the parties' negotiating skill (or lack of it), tax considerations, the buyer's expectation about the future course of rent control and a host of financial and psychological reasons which are difficult to quantify and are fact specific to the particular purchase. Adam Smith's invisible hand is indeed, often invisible. The inability to fathom, much less measure, the factors which result in a specific purchase price led to the widespread emergence of the MNOI system which avoids the quicksand into which such inquiries would lead.

Second, the trial court placed undue reliance on this Court's opinion in Searle I. Upholding the Board's policy existing at that time, Searle I rejected the plaintiffs' asserted constitutional right to pre-purchase-date AGAs. Searle I stated that if the rent were not yielding a fair return, plaintiffs had recourse to the IRA system where owners could obtain an adjustment sufficient to give them a "fair return on investment" pursuant to section 12(i) of the Ordinance. (197 Cal.App.3d at 1256-58 & ns. 3 and 5.)

Searle I, however, has been overtaken by events. The ephemeral fair rate of return system to which this Court relegated the Searles was exposed in Searle II as Berkeley's version of the Emperor's New Clothes -- a gossamer fabric providing scant protection for owners' constitutional rights. With the impetus of Searle II and a vast administrative record, Berkeley's Board has woven a sturdier garment from its pre-existing MNOI fabric.¹⁹

B. The Trial Court Read Searle II Far Too Narrowly: By Directing That The Searles, Who Purchased In 1984, Were Entitled To An Inflation Adjustment From 1979, The Court Implicitly, If Not Explicitly, Supported The Board's Decision To Index Inflation For All Properties From 1979.

The trial court held that Searle II offered no support to the contention that properties purchased after rent control were entitled to an inflation adjustment from 1979. The court concluded that the "issue was not presented, argued or decided in that case. . . . Nothing in the decision orders that the Searles were entitled to [the] benefit of any inflationary adjustment for a period before they purchased the property." (7JA 119, at 2159.) But, the trial court placed too narrow a construction on Searle II. True, the parties never argued whether inflation indexing would reach back to

¹⁹ Moreover, the Board had substantially altered the very policy which Searle I upheld, the denial of lost AGAs to subsequent purchasers. Regulation 1278.5 now permits owners to recapture lost AGAs when those AGAs were lost as a result of the good faith failure to register. The regulation applies regardless of purchase price or the owner's investment in the property.

the base year regardless of changes in ownership. The reason is obvious. Former Regulation 1264 permitted indexing from 1980 regardless of changes in ownership. Neither the City Attorney or anyone else involved in that litigation challenged the premise -- **based on the Board's entrenched MNOI system** -- that any inflation adjustment directed by this Court would date from the base year. The trial court failed to explain why this Court even entertained debate on whether 1980 was the proper base year if, in fact, this Court and all concerned did not assume that the Searles would be entitled to an inflation adjustment from the proper base year.

C. The Trial Court's Order Places Properties Purchased After 1984 In A Worse Position Than Had Searle II Held That 40 Percent Indexing From 1979 Was Proper.

The trial court's decision places many rents lower than they would have been had Searle II upheld 40 percent indexing, but required such indexing to apply to all properties from 1979. Specifically, a straightforward calculation reveals that properties changing hands after 1984 would have garnered higher rents in 1992 under 40 percent indexing from the base year than under the decision below. Post-1984 purchasers would have fared better had the Searles lost. (6JA 111, at 2117; while stricken by the trial court, the chart contains an irrefutable calculation.)

II. THE TRIAL COURT DEvised ITS OWN FAIR RETURN METHODOLOGY, DISREGARDING THE ARDUOUS AND THOROUGH WORK OF THE BOARD AND ITS CONSULTANTS; IN LIEU OF THE BOARD, THE COURT DEvised AN INHERENTLY UNMANAGEABLE SYSTEM.

A. The Trial Court Devised Its Own Rate Of Return System, Usurping The Role Of The Board And Violating Settled Precepts Of Judicial Review Of Administrative Action.

During the Board's discussions, Commissioner Marsh rightly noted that " This is a very complicated and difficult social policy that we have to put forward, it's not just a mater of economics. It's social policy as well." (AR 917B.) The trial court's most fundamental error was arrogating to itself that policy-making function, notwithstanding the elected Board's obligation to "set

fair and equitable rents", to "issue regulations" and "to make studies." (Ordinance, §§ 6.5(f)(5-7.) In doing so, the court undermined the Board's rule-making efforts, superimposing its own view of "fair return" on the agency.

The Court's words in Pitts v Perluss (1962) 58 Cal.2d 824, 832 are particularly appropriate here:

We confront a situation here which graphically illustrates the wisdom of the general rule that the court should not substitute its judgment for that of an administrative agency which acts in a quasi-legislative capacity.

Specifically, the court ignored the longstanding existence of Berkeley's MNOI system, the type of fair return model on which tenants, owners and investors had long relied (Dean 27 Cal.2d, at 880-881; Anderson, 192 Cal.App.3d, at 1343) and to which the court owed deference. In its place it substituted its own fair rate of return on investment system. The trial court indicated that a fair rate of return should be measured by the capitalization rate obtained by dividing the purchase price into the NOI on the date of sale and that any adjustment which provided the owner with a higher rate of return was unwarranted. (7JA 119, at 2160-2161.) The court's Statement of Decision suggested how the Board could determine if the prices post-1979 owners paid reflected expectations of an inflation adjustment warranting an adjustment in their NOI. (Id., at 2140-2142.) The court advised the Board to examine and interpret sales data focusing on sales price, capitalization rates and gross rent multipliers:

By comparing data from Berkeley sales during various times and by comparing the data to that of comparable properties in neighboring communities, it should be possible to determine the effect of various events relating to rent control on prices. For example, one might examine sales of rental property for a one-year period before and after the Fisher decision. Did the capitalization rates go down and the GRM's go up in Berkeley, as one would expect if buyers were now paying more because of expectations based on that decision? Was any change in capitalization or GRM's in Berkeley

significantly different in that period from changes in nearby communities without rent control?

(7JA 119, at 2141-2142 & n.1.) Whatever the wisdom of such a system, it has never been adopted by the Board. Settled principles of judicial review dictate that we need argue no further; reversal is mandated on the ground that the court overstepped its bounds in supplanting the Board's choice of a fair return system. We now explain why that system is unmanageable.

B. The Court's System Is Essentially A Rate Of Return On Investment System, Discredited In The Literature, Rejected By The Board And Its Consultants, Unmanageable And Incompatible With Birkenfeld's Command Of Prompt Adjudication Of Rent Board Petitions.

The trial court's fair rate of return system focuses on the price investors paid and determines from that price whether owners are entitled to a rent adjustment to earn a fair return on investment. In his Guidelines article, Ken Baar detailed the shortcomings of this approach. He explained that since real estate investing is indeed motivated by expectations of **future** income, a return on investment system is inconsistent with rent control:

Since investment is a business decision which is governed by expectations of future income, the use of investment as a measure of what income shall be permitted defeats the purpose of rent regulation, which is designed to result in result in something other than the rents which would be expected in the unregulated market. Such a standard permits the regulated to regulate rents.

(Guidelines, at 792.)²⁰ The Board's consultants also discussed theoretical and practical difficulties with the standard in their report on fair return. (AR 479-482B; 844B, 848-849B.)

²⁰ Baar also noted that "[R]ate designation in a rent control context becomes very seriously flawed, because for practical and policy reasons, consideration of the multitude of factors which govern investors' rate of return calculations . . . is inappropriate in a rent control context." (Guidelines, at 809.) (Hamilton told the Board that "There is "no technical answer to the question, 'What is fair?'" (AR 869B.)

The trial court's own return on investment methodology is particularly unworkable. No question exists that most, if not all, owners who purchased after 1979 would request an adjustment based on their expectation that Berkeley would index for inflation from the base year. They would point to (1) the Board's MNOI system which consistently has focused on the property itself and the base year NOI of that property and (2) a succession of statements by the City, the Board and the courts that inflation would be considered in adjusting rents. These statements included: counsel's statement to this Court on July 5, 1983 that the Board would consider inflation in IRA petitions; Cotati and Fisher, which required the Board to account for inflation; the 1985 Baar report recommending that the Board index NOI from the base year regardless of changes in ownership; the Board's promise to the Ninth Circuit in Amberhill that it would consider inflation; former Regulation 1264 carrying out the recommendations in 1987; and, finally, Searle II.

Moreover, each individual owner would attest to the effect of his or her expectations on the purchase price. Owners will no doubt state that they would have paid far less, but for their expectation that Berkeley would one day install a fair system.²¹

Assuming an owner proved that he or she factored such an expectation into the purchase price, what then? Would the Board grant adjustments tied to the extent of each owner's individual expectation? Would the owner be entitled to a particular rate of return on all the funds invested or only on the additional funds invested attributable to that expectation? What would the rate be?

²¹ In response to the Tentative Decision, BPOA submitted affidavits from owners attesting to their reliance on the Board's MNOI policy and court opinions and expectations of 100 percent indexing when purchasing their properties. (6JA 113 and 114.) The court struck these declarations; they are cited as exemplars of the declarations owners would submit under the trial court's system.

During the argument, the City's counsel stated that a sworn affidavit would suffice to show that an owner purchase price had been predicated on expectations of an inflation adjustment. (RT 5/26, at 80.) Counsel's statement ignores the contentious nature of rent board hearings.

Would it change from year to year? Having created a rate of return on investment system, would not owners who purchased prior to 1979 seek relief under that system? Questions beget more questions, perhaps answerable, but when and by whom? How many thousands of pages would be consumed by the administrative record leading to these regulations? Would those regulations be challenged? What expertise would the Board need to decide petitions? How many petitions would owners file seeking adjustments? How would tenants contest them? How many appealed? How long would the Board take to decide each petition? How many petitions would reach Superior Court? How many would come to this Court? How would financial institutions gauge lending limits? How would the trial court's system affect the flow of capital into the Berkeley rental property market? It boggles the mind.

Searle II recognized the undue length of time consumed by the Searles' own case and the Birkenfeld problems raised by such delay. (7JA 132, at 2214-2215.) The trial court below recognized "the problem of long delays in the IRA process" and that "Few IRA hearings have been resolved in the 120 days called for by the ordinance." (7JA 119, at 2162, 2163.)²² Nonetheless, the court relegated post-1979 owners to the IRA process, and an untried one at that. (7 JA 119, at 2159.) Both the City's counsel and the trial court contemplated the "administrative nightmare" posed by the IRA process envisioned by the court. (RT 5/26, at 84.) That process cannot satisfy Birkenfeld.

III. THE ERRORS WHICH TAINTED THE TRIAL COURT'S DECISION DENYING SEARLE INCREASES TO PROPERTIES PURCHASED AFTER 1979 APPLY AS WELL TO THE OPINION DENYING POST-1979 BUYERS ADJUSTMENTS BASED ON HISTORICALLY LOW OR NON-MARKET BASE YEAR RENTS; MOREOVER, THE PLAINTIFFS NEVER ARGUED THAT POST-1979 PURCHASERS AS A CLASS SHOULD BE DENIED SUCH ADJUSTMENTS.

We need not repeat the points made in critiquing the trial

²² The trial court record includes the November 21, 1991 Rent Board "Appeals Log" which lists cases awaiting decision and details the long delays in the process. (4 JA 62, at 1119-1129.)

court's denial of Searle increases to properties purchased after 1979. The court made three principal errors in denying such properties the benefit of Regulations 1262(C)(3) (the comparable base year rent regulation) and 1280 (the HLR regulation). First, various versions of Regulation 1262(C) in effect prior to 1991 all allowed adjustment of base year NOI regardless of changes in ownership. If base year rents were not set in an arms-length transaction, the current owner of the property could seek an adjustment of base year NOI even if the property had been purchased since 1979. Second, the consultants explained that a determination that base year rents were fair must be an integral part of the MNOI fair return system they recommended. ("The MBYNOI definition of fair return then adds the corollary that if base-year NOI has been determined to be fair, then properly indexed base-year NOI does represent a fair return on a landlord's investment.") (AR 496B.) Third, while plaintiffs did argue Regulations 1262(c)(3) and 1280 were invalid, they never distinguished between pre-1979 and post-1979 purchases. Nor could they. They contended that the Board's prior version of Regulation 1262(c) satisfied Birkenfeld's and Vega's requirement that the Board provide for adjustment of base year rents not set by the market; that regulation applied equally to those who purchased before and after 1979. Finally, plaintiffs never asserted that these regulations did not apply to properties purchased after 1979 and thus waived that argument. (Morgan, 231 Cal.App.3d at 258-259.)

IV. THE TRIAL COURT ERRED IN ADMITTING DETAILED DECLARATIONS BY

CITY STAFF ATTACKING THE BOARD'S REGULATIONS; THOSE DECLARATIONS WERE NOT BEFORE THE BOARD AND SHOULD NOT BE CONSIDERED BY THIS COURT.

In the trial court, the City relied on extensive declarations. The 56-page Mayer declaration, (2JA 34, at 465-520), stated his opinion that the regulations provided for rent increases much greater than those required by Fisher. Plaintiffs filed two declarations of Steven Barton setting forth his opinion of the regulations' effect on the City. (3JA 45, at 783-808; 5JA 81, at 1621-1667.) The Board and BPOA objected to these declarations (3JA 59, at 975, 989-991; 4JA 64, 1179-1193; 6JA 87, at 1817-1820.) They were not part of the administrative record and should be excluded. (Morgan, 231 Cal.App.3d at 258-259; Shappell Industries, Inc., 1 Cal.App.4th at 233-234.)

Barton appeared before the Board on September 10, 1991, and spoke for several minutes raising several general objections. (AR 793B.) The City never submitted the detailed objections included in the declarations to the Board and they are not in the administrative record. The trial court's consideration of the declarations was an error which this Court should not repeat.

V. THE BOARD'S DECISION TO ADJUST NOI FOR ALL PROPERTIES REGARDLESS OF CHANGES IN OWNERSHIP FELL WELL WITHIN ITS DELEGATED AUTHORITY, COMPORTED WITH THE BOARD'S EXISTING MNOI SYSTEM, FOLLOWED THE RECOMMENDATION OF EXPERTS, WAS REASONABLE AND MUST BE UPHELD.

As the Court stated in California Hotel & Motel Assn., 25 Cal.3d at 212-213, "A reviewing court will ask three questions: first, did the agency act within the scope of its delegated authority; second, did the agency employ fair procedures; and third, was the agency action reasonable." (See, Garamendi, 6 Cal.App.4th at 1422.)

The answer to these questions is an unqualified "Yes!" First, Article XVII of the Berkeley City Charter vests exclusive authority in the elected Board to "regulate residential rents." (§§ 120, 122.) The Ordinance expressly authorizes the Board to set rents and adopt regulations. (§ 6f.1, 5 and 6.) (Calfarm Insurance Co.,

48 Cal.3d, at 824-825 (ordinance grants implied power to Board to implement Ordinance); Dean, 27 Cal.2d, at 881; (Legislature may confer upon agency the "'power to fill up the details'" by prescribing regulations); Garamendi, 6 Cal.App.4th at 1420-1421; Creighton v. City of Santa Monica (1984) 160 Cal.App.3d 1011, 1019 ("electorate intended to have the rent control law administered by a popularly elected Rent Control Board independent of City Council interference or control."))

Second, the Board acted with scrupulous fairness. The Ordinance did not compel the Board to retain consultants or to hold public hearings. Yet, the Board retained consultants and heard hours-on-end of public testimony. And, the Board did not adopt every landlord suggestion: 1979, not 1978 was selected as the base year; the prior AGAs were deemed accurate; the CPI less-shelter index was used, although opposed by owners who also opposed the phase-in of Searle increases. (AR 696-697B.)

Third, the regulations were reasonable. (Payne, 16 Cal.3d, at 656-657.) Three fundamental bases for that conclusion are:

1. The regulations meshed with the Board's overall regulatory scheme in place since 1981 and endorsed by the consultants. Landlords, tenants and investors reasonably relied on that scheme which is entitled to great weight. (Dean, 27 Cal. 2d, at 880-881; Cole, 3 Cal.App.4th at 698; (construction of ordinance by agency entitled to great weight "especially applicable where, as here, the Board's interpretation is long-standing and has remained uniform."); Anderson, 192 Cal.App.3d at, 1343.) No one contests that the Board's pre-existing regulatory scheme was **property specific** with no distinction between properties which had changed hands and those in continuous ownership. Buyers assumed all liabilities and benefits of the prior owner including liability for unpaid fees and entitlement to adjustments for capital improvements performed by the prior landlord. (AR 631-632B; 998B; 1594B.)

2. The regulations were the product of experts' advice that the Board adopt a consistent AGA and IRA methodology. The system defines fair return as 100 percent indexing from the base year NOI

which is presumed fair but may be adjusted if not fair. (Reg. 1264; AR 496-501.) The Board was not required to "fix rents by application of any particular standard or formula." (Fisher, 37 Cal.3d at 680; Cole, 3 Cal.App.4th at 700.) The Board had discretion to adjust for inflation exclusively through the AGA process. The consultants had told the Board that all communities which focus on NOI "treat the AGA process as the proper across-the-board vehicle for keeping rents or landlord net operating income indexed for inflation." (AR 104B.) Cotati had adopted 100 percent indexing through the AGA process. (AR 108B.) The Board also had discretion to ensure a speedier and less acrimonious resolution of petitions. Ms. Olds noted that 100 percent indexing of base rent across-the-board would "take care of 99 percent of the owners." (AR 819B.) HR&A stated that higher the level of indexing, "the lower the probability that successful fair return petitions would be filed by property owners." (AR 465B.)

Although there was no detailed attack on granting all properties inflation adjustments from the base year, the consultants rejected the general suggestion that inflation should only be indexed from the date of purchase. Hamilton stated that with "100% indexing of NOI . . . you avoid the whole issue." (AR 838B.) Discussing buildings which had changed hands, a consultant stated that regulators should be careful not to create a particularly favored method of financing. (AR 840B.)

Courts defer when agency action requires such expertise. (Perluss, 58 Cal.2d at 832, 835; Golden Cheese Co. of California, 230 Cal.App.3d 547, 556 ("establishment of minimum prices involves highly technical matters requiring the assistance of skilled and trained experts and economists"); Ralph's Grocery Store, 69 Cal.2d at 176 (deferring to "continuous flexible and expert regulation."))

3. The Board reasonably construed Searle II, Birkenfeld and Vega. It was not arbitrary for the Board to draft Regulations 1262(C)(3) and 1280 to conform to language in Birkenfeld and Vega that base rents under the ordinance should "reasonably be deemed to reflect general market conditions." Similarly, given this Court's

concerns about delay and statements that indexing could "conceivably be less than 100 percent" and its order requiring indexing to date from 1979, notwithstanding the Searles' 1984 purchase, the Board reasonably indexed inflation from the base year for all properties, including those purchased after 1979. In creating one coherent standard applicable to both AGA and IRA petitions, the Board also heeded Searle II's concern about the need for prompt adjudication of petitions. The consultant and attorney confirmed that 100 percent indexing was both the simplest to administer and would be upheld by the courts. (AR 850-851B.)

CONCLUSION

A decade ago Berkeley property owners launched a facial attack on the Ordinance, complaining that it was inherently so unfair that it jeopardized their constitutional rights. Responding to that assault, the City advised the appellate courts to ignore the owners' ill-founded hysteria. Give the Board a chance. The Ordinance was sufficiently flexible to protect constitutional rights. The City cited Nelson v. Dean (1946) 27 Cal.2d 873 for the proposition that "If and when the Board does interpret "'fair return on investment,'" the courts will be required to give "'great weight to the Board's interpretation." (Respondent's Brief in Fisher v. City of Berkeley, No. 1 Civ. 52332, at 34.) After fits and starts and this Court's intervention, the Board has now adopted an equitable fair return system. Following the advice tendered by Berkeley's counsel, this court, giving great weight to those regulations, will uphold them.

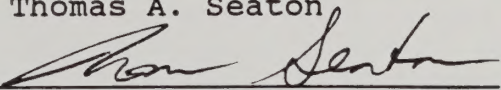
Respectfully submitted:

Dated: April 16, 1993

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Subchapter G. Regulations for 1981-1987 and for 1988-1990

1261. Purpose of Subchapter G.

The purpose of this subchapter is to protect tenants from unreasonable rent increases, while at the same time allowing rent owners who provide landlords with a fair return on their investment. It is the intent of these regulations that individual upward adjustments in the year ceilings be made only when the landlord demonstrates that such adjustments are necessary to provide the landlord with a fair return on investment under the Rent Ordinance provisions 1263, 1267, 1268, 1269, 1270, 1271, 1272, 1273 and 1274, or as required by the California or Federal Justice Court (Section 1275).

1262. Base Year Net Operating Income.

(a) The base year shall be the calendar year of 1979, or the calendar year of 1980 for rental units specified in Section 12.75(b) of the Ordinance, except as otherwise provided in subsection (b) below.

(b) If the necessary data for the base year is not available in 79 the base year is deemed to be the calendar year for which the tenant has the records available. If the tenant has no records, the hearing examiner may, at his discretion, determine the appropriate base year. Twelve months prior to the base year shall be a base year.

SELECTED BOARD REGULATIONS
1981-1987

CURRENT REGULATIONS WILL BE FILLED UNDER SEPARATE COVER

If the Board determines that the base year net operating income was exceptionally high or low for either of the following reasons:

(a) The landlord's operating and maintenance expenses in the base year were unusually high or low in comparison to other years. In such instances, adjustments may be made in calculating net operating income for the base year operating expenses related to the property for the property over a reasonable period of time.

(b) The rent in the base year was exceptionally high or low due to the fact that the rent was not established in an arms-length transaction or was otherwise not an arms-length transaction.

1263. Definition of Net Operating Income.

The net operating income for a property for any period shall be the gross income less the following: property taxes, insurance, maintenance and operating expenses, and the amortized cost of capital improvements (pursuant to Section 1274). Gross income shall be the total of the gross rents actually collected from a property in 1979 or 1980, plus any other consideration received or received for or in connection with the use or occupancy of the property and including charges for utility reimbursements from tenants, parking, or any other facilities or items. Gross rents collected shall include the unpaid amount of any prorated rents.

Subchapter C. Standards for Individual Rent Ceiling Adjustments

1261. Purpose of Subchapter.

The purpose of this subchapter is to protect tenants from unwarranted rent increases, while at the same time allowing rent levels which provide landlords with a fair return on their investment. It is the intent of these regulations that individual upward adjustments in the rent ceilings be made only when the landlord demonstrates that such adjustments are necessary to provide the landlord with a fair return on investment under the Rent Ordinance (Sections 1262, 1267, 1268, 1269, 1270, 1272, 1273 and 1276) or as required by the California or United States Constitution (Section 1275).

1262. Base Year Net Operating Income.

(A) The base year shall be the calendar year of 1979, or the calendar year of 1981 for rental units specified in Section 13.76.050F of the Ordinance, except as otherwise provided in subsection (B) below.

(B) If the necessary data for the base year is not available or if the base year is demonstrated to be inappropriate for reasons other than the way the records are kept for bookkeeping or income tax purposes, the hearing examiner may determine that another more appropriate consecutive twelve month period shall be used instead as a base year.

(C) The base year net operating income may be adjusted by the Board if the Board determines that the base year net operating income was exceptionally high or low for either of the following reasons:

(a) The landlord's operating and maintenance expenses in the base year were unusually high or low in comparison to other years. In such instances, adjustments may be made in calculating such expenses so the base year operating expenses reflect average expenses for the property over a reasonable period of time.

(b) The rent in the base year was exceptionally high or low due to the fact that the rent was not established in an arms-length transaction or was otherwise not set under market conditions.

1263. Definition of Net Operating Income.

The net operating income for a property for any period shall be the gross income less the following: property taxes, reasonable maintenance and operating expenses, and the amortized cost of capital improvements (pursuant to Section 1267). Gross income shall be the total of the gross rents lawfully collectible from a property at 100% occupancy, plus any other consideration received or receivable for or in connection with the use or occupancy of rental units and housing services (including consideration from laundry, parking, or any other facilities or fees). Gross rents collectible shall include the imputed rental value of owner-occupied units.

Subchapter C. Standards for Individual Rent Ceiling Adjustments

1261. Purpose of Subchapter.

The purpose of this subchapter is to protect tenants from unwarranted rent increases, while at the same time allowing rent levels which provide landlords with a fair return on their investment. It is the intent of these regulations that individual upward adjustments in the rent ceilings be made only when the landlord demonstrates that such adjustments are necessary to provide the landlord with a fair return on investment under the Rent Ordinance (Sections 1262, 1267, 1268, 1269, 1270, 1272, 1273 and 1276) or as required by the California or United States Constitution (Section 1275).

[Revised Regulation 1261 effective May 27, 1987.]

1262. Base Year Net Operating Income.

(A) The base year shall be the calendar year of 1979, or the calendar year of 1981 for rental units specified in Section 13.76.050F of the Ordinance, except as otherwise provided in subsection (B) below.

(B) If the necessary data for the base year is not available or if the base year is demonstrated to be inappropriate for reasons other than the way the records are kept for bookkeeping or income tax purposes, the hearing examiner may determine that another more appropriate consecutive twelve month period shall be used instead as a base year.

(C) The base year net operating income may be adjusted by the Board if the Board determines that the base year net operating income was exceptionally high or low for either of the following reasons:

(a) The landlord's operating and maintenance expenses in the base year were unusually high or low in comparison to other years. In such instances, adjustments may be made in calculating such expenses so the base year operating expenses reflect average expenses for the property over a reasonable period of time.

(b) The rent in the base year was exceptionally high or low due to the fact that the rent was not established in an arms-length transaction or was otherwise not set under market conditions.

[Revised Regulation 1262 effective May 27, 1987.]

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The net operating income for a property for any period shall be the gross income less the following: property taxes, reasonable maintenance and operating expenses, and the amortized cost of capital improvements (pursuant to Section 1267). Gross income shall be the total of the gross rents lawfully collectible from a property at 100% occupancy, plus any other consideration received or receivable for or in connection with the use or occupancy of rental units and housing services (including consideration from laundry, parking, or any other facilities or fees). Gross rents collectible shall include the imputed rental value of owner-occupied units.

Subchapter C. Standards for Individual Rent Ceiling Adjustments.

1261. Purpose of Subchapter.

The purpose of this Subchapter is to protect tenants from unwarranted rent increases, while at the same time allowing rent levels which provide landlords with a fair return on their investment.

It is the intent of these regulations that individual upward adjustments in the rent ceilings be made only when the landlord demonstrates that such adjustments are necessary to provide the landlord with a fair return on investment.

1262. Base Year Net Operating Income.

(A) The net operating income, as defined in Section 1263, which was produced by a property during the base year shall be presumed to provide the landlord of that property with at least a fair return on investment. The base year shall be the calendar year of 1979, except as otherwise provided in subsection (B) below.

(B) If the necessary data for 1979 is not available or if 1979 is demonstrated to be inappropriate as a base year (for reasons other than the way the records are kept for bookkeeping or income tax purposes), the hearing examiner may determine that another more appropriate consecutive twelve month period shall be used instead as a base year.

(C) The Board or hearing examiner may determine that the base year net operating income yielded more or less than a fair return on investment. Upon making such a determination, the base year net operating income may be adjusted accordingly. Factors that may be considered in making such a determination are:

- (1) the fact that the rent was exceptionally high or low, due to a family or special relationship between the landlord and tenant, or other factors;
- (2) the fact that the landlord's operating and maintenance expenses in the base year were exceptionally high or low; in such instances, adjustments may be made in calculating such expenses so they reflect average expenses for the property over a reasonable period of time;
- (3) other factors which would cause the application of the base year net operating income to result in gross inequity to either the landlord or the tenant;
- (4) the provisions of the Ordinance or other sections of this Subchapter.

1263. Definition of Net Operating Income.

The net operating income for a property for any period shall be the gross income less the following: property taxes, reasonable maintenance and operating expenses, and the amortized cost of capital improvements (pursuant to Section 1267). Gross income shall be the total of the gross rents lawfully collectible from a property at 100% occupancy, plus any other consideration received or receivable for or in connection with the use or occupancy of rental units and housing services (including consideration from laundry, parking, or any other facilities or fees). Gross rents collectible shall include the imputed rental value of owner-occupied units.

24. Maintenance of Net Operating Income.

Landlords shall be entitled to maintain the net operating income produced by a property in the base year, or as adjusted pursuant to Section 1262 (C). Rent ceiling levels shall be adjusted prospectively, according to the provisions of this chapter, to maintain that net operating income, upon a showing that the net operating income in the comparison year has decreased from the base year (or the adjusted base year) level, but only insofar as the rent ceiling levels have not already been adjusted by any general adjustments approved by the Board. The comparison year shall be the most recent calendar or fiscal year, unless another period is found by the hearing examiner to be more appropriate.

25. Maintenance and Operating Expenses.

(A) Maintenance and operating expenses shall include all reasonable maintenance and operating expenses for a unit or property, including self labor, except as provided in subsection (B) below.

(B) Maintenance and operating expenses shall not include the following expenses:

- (1) avoidable expense increases since the base year;
- (2) mortgage principal and interest payments;
- (3) any penalties, fees or interest assessed or awarded for violation of the Ordinance or these regulations;
- (4) legal, accounting or filing fees incurred in connection with any Board proceeding or any court action related to such a proceeding (however, such fees may be recoverable pursuant to Sections 1247);
- (5) organization or association dues or fees;
- (6) legal and other costs for any evictions brought under Sections (a) (9) or (10) of the Ordinance;
- (7) depreciation of the property;
- (8) expenses for which the landlord has been reimbursed by any security deposit, insurance settlement, judgment for damages, agreed upon payments, or any other method.

(C) Any non-recurring expense shall be amortized over a reasonable period of time, to allow the expense to be recovered during that period. After that time, the next rent ceiling shall automatically be adjusted downward by the amount of the upward rent ceiling adjustment attributable to that expense.

1264. Maintenance of Net Operating Income.

(A) The landlord is entitled to maintain the net operating income produced by the property in the base year, adjusted by 40% of the percentage increase in the Consumer Price Index (CPI) since June 1, 1980, if 1979 is the base year, or since the midpoint of any alternative base year. Rent ceilings shall be adjusted prospectively, subject to the limitations set forth in Section 1274, upon a showing that the net operating income in the comparison year is not equal to the base year net operating income adjusted by 40% of the percentage increase in the CPI since June 1, 1980, if 1979 is the base year, or since the midpoint of any alternative base year.

(B) The percentage increase in the CPI shall be determined by comparing the most recently reported monthly CPI for All Urban Consumers for the San Francisco-Oakland Metropolitan Area, U.S. Bureau of Labor Statistics, at the time of the filing of the petition to the monthly CPI for June 1, 1980 (i.e. 248.0), or the monthly CPI for the midpoint of any alternative base year, whichever is later.

(C) Any individual adjustment established pursuant to this section shall take into account the extent of any annual general adjustments for which the landlord is entitled, and the individual adjustment shall be limited accordingly. The comparison year shall be the most recent calendar or fiscal year, unless another period is found by the hearing examiner to be more appropriate.

New Regulation 1264 shall become effective July 1, 1987 and shall apply to all petitions filed after July 1, 1987.

1265. Maintenance and Operating Expenses.

(A) Maintenance and operating expenses shall include all reasonable maintenance and operating expenses for a unit or property, including self labor, except as provided in subsection (B) below.

(B) Maintenance and operating expenses shall not include the following expenses:

- (1) avoidable expense increases since the base year;
- (2) mortgage principal and interest payments;
- (3) any penalties, fees or interest assessed or awarded for violation of the Ordinance or these regulations;
- (4) legal, accounting or filing fees incurred in connection with any Rent Board proceeding or any court action related to such a proceeding (however, such fees may be recoverable pursuant to Sections 1247);
- (5) organization or association dues or fees;
- (6) legal and other costs for any evictions brought under Sections 13(a) (9) or (10) of the Ordinance;
- (7) depreciation of the property;

1265. Maintenance and Operating Expenses (Continued).

(8) expenses for which the landlord has been reimbursed by any security deposit, insurance settlement, judgment for damages, agreed upon payments, or any other method.

(C) Any non-recurring expense shall be amortized over a reasonable period of time, to allow the expense to be recovered during that period. After that time, the rent ceiling shall automatically be adjusted downward by the amount of the upward rent ceiling adjustment attributable to that expense.

268. Recent Rent Changes.

(A) Purpose. The purpose of this Section is to provide an additional one-percent ceiling adjustment for units for which there have been no or minimal rent increases in recent years. The 10% figure takes into account general increased costs to landlords in the 1976-1979 period, and the fact that landlords generally realized substantial property tax savings as a result of Proposition 13.

(B) Additional Rent Increase. In addition to any rent ceiling adjustment pursuant to Sections 1262-1267, and Sections 1269-1270, the rent ceiling for any unit may be further increased by the dollar difference between 10% of the rent in effect on January 1, 1976 and the dollar amount that the rent was increased for that unit between January 1, 1976 and December 31, 1979, if:

(1) the landlord has complied with Measure I, Ordinance 5212, and Measure D in all respects; and

(2) the tenant's use of and benefit from the unit has not been impaired by a reduction in housing services or living space, or by other factors, subsequent to January 1, 1976; and

(3) the rent in effect on December 31, 1979, was no more than 10% greater than the rent in effect on January 1, 1976.

(C) Rent ceiling adjustments pursuant to this section may only be made one for any unit.

269. Changes in Space or Services; Substantial Deterioration.

(A) Increases in Space or Services. Rent ceilings shall be adjusted upward pursuant to the provisions of Sections 1262-1267, for increases in the living space or housing services (including furniture, furnishings, or equipment) provided for a unit, where such increases in space or services result in unavoidable increases in actual expenses, and where such increases in space or services are either unavoidable or are provided by the landlord in good faith to primarily benefit the tenant(s).

(B) Decreases in Space or Services. Rent ceilings shall be adjusted downward for decreases in living space or housing services provided for a unit, by an amount equal to the rent ceiling in effect, multiplied by the percentage by which the tenant's use of and benefit from the unit has been impaired by the reduction in living space or housing services.

(C) Substantial Deterioration. Rent ceilings shall be adjusted downward for any substantial deterioration in a rental unit or property, other than as a result of either normal wear and tear or wilful destruction of the property by the tenant, by an amount equal to the rent ceiling in effect, multiplied by the percentage by which the tenant's use of and benefit from the unit has been impaired by the deterioration.

(D) Failure to Provide Adequate Services. Rent ceilings shall be adjusted downward for any failure by the landlord to provide adequate housing services, or to comply substantially with applicable state rental housing laws, local housing, health and safety codes, or the rental agreement. The amount of the downward adjustment shall be equal to the rent ceiling in effect, multiplied by the percentage by which the tenant's use of and benefit from the unit has been impaired by the landlord's failure or non-compliance.

1275. Fair Return on Investment.

No provision of these regulations shall be applied so as to prohibit the granting of an individual rent adjustment that is demonstrated necessary by the landlord to provide the landlord with a fair return on investment.

Investment is defined as either equity or property value, as appropriate, pursuant to regulations of the Rent Stabilization Board. However, until such time as the Board adopts regulations setting forth specific guidelines to be used in determining the rent ceiling level for a unit(s) which would provide the landlord with a fair return on investment based on equity or property value, the rent ceiling level necessary to provide a fair return on investment shall be calculated according to Sections 1262-1274 of the Board's regulations.

1275. Fair Return under Constitution.

(A) The landlord is entitled to any increase in rent which is necessary to avoid a confiscatory taking under the California and United States Constitutions. In determining whether the landlord is entitled to a rent increase under this regulation, the Board may consider all relevant factors, including but not limited to the following:

(1) The return the landlord receives from the property, including the income generated by the property, tax benefits derived from the property, and any appreciation in value of the property; .

(2) The effects on the landlord's return of the decrease in the purchasing power of the dollar due to inflation;

(3) The return generated by the property under free market conditions in the year immediately preceding the imposition of rent control; and

(4) Changes in the landlord's return on the property since the year immediately preceding rent control.

Any rent increases granted by the Board pursuant to this regulation shall not be subject to the limitations set forth in Regulation 1274.

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28

No. A059403

COURT OF APPEAL OF THE STATE OF CALIFORNIA
IN AND FOR THE FIRST APPELLATE DISTRICT
DIVISION FIVE

SAVE AFFORDABLE HOUSING, et al.,	)	CIVIL
CITY OF BERKELEY, etc.	)	No. A059403
	)	
Petitioners, Respondents & Cross-Appellants	)	
	)	
vs.	)	
	)	
CITY OF BERKELEY RENT STABILIZATION BOARD, et al.	)	
	)	
Respondents, Appelants & Cross-Respondents	)	Alameda County
	)	Superior Court
	)	No. 683721-5
	)	
BERKELEY PROPERTY OWNERS' ASSOC.,	)	
	)	
Intervenor, Appellant and Cross-Respondent	)	
	)	
	)	
DAGMAR SEARLE and JOHN R. SEARLE,	)	
	)	
Intervenors and Amici Curiae	)	
	)	

BRIEF AMICUS CURIAE OF DAGMAR SEARLE AND JOHN R. SEARLE

On Appeal from the Final Judgment and Order of the
Superior Court of the State of California,
County of Alameda

THE HONORABLE JOHN SUTTER, JUDGE

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Laws: Lessons of a Decade, (1983)
35 Rutgers L.J. 723

Rethinking Rent Control: An Analysis of Fair
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SUMMARY OF ARGUMENT

The Trial Court very soundly recognizes that the Rent Board has wide discretion, and that it had good rational basis for adopting the regulations which had been challenged in this litigation. But in limiting the relief which post 1979 purchasers can reap from these regulations, the Trial Court has committed a grievous error. This error lead the Court to encroach on the Board's legitimate discretion and to issue orders which go well beyond the proper scope of review.

The Trial Court has ordered the Rent Board to roll back rents for all landlords who have purchased their properties after 1979, and to index the net operating incomes in these properties only from the date of the most recent owner's purchase. The Court based this order on the erroneous presumption that in rental properties purchased after 1979, the rents in effect at the time of purchase yielded fair return. First of all, there is no factual basis for this presumption whatever. Secondly, this presumption is incompatible with the basic presumption of the Berkeley rent stabilization system, which, like most modern systems, is designed to stabilize all rents by reference to rents in a base year, which are presumed to have yielded fair return. Thirdly, for properties that changed hands after 1979, the trial court's presumption would perpetuate the freezing of net incomes at the 1979 dollar level up to the time of purchase, would result in denial of equal protection to the new owners, and would result in widely disparate rents for comparable properties. Finally, the

rollback ordered by the Trial Court is more severe than the rollbacks proposed by Measures E and H which the Berkeley voters rejected in 1992, and is worse for recent owners than the old 40% indexing regulation. These defects would certainly lead to multiplicity of lawsuits.

The Court's proposal that its presumption could be rebutted by inserting the discredited return on investment standard into the existing maintenance of net operating income standard, is unworkable. The Court's proposal that sales figures be surveyed contradicts the MNOI system, which for good reasons ignores sales figures.

The Trial Court puts forward its erroneous presumption in the form of a special definition of "fair return" for a particular class of owners. This is improper, because the definition of "fair return" as such was not an issue presented to the trial court. The Rent Board, in response to one of the commands in Searle v. City of Berkeley Rent Stabilization Board, (1990) A044761 (hereafter referred to as Searle II), did adopt a regulation defining "fair return", (the new Regulation 1264), but this regulation was not challenged in this proceeding, nor in any other proceeding to date. And the Trial Court's special definition in terms of fair return on investment, directly contradicts this new Regulation 1264, which defines "fair return" for all owners as maintenance of base year net operating income fully indexed for inflation.

ARGUMENT

I. THERE IS NO BASIS FOR THE PRESUMPTION THAT IN PROPERTIES PURCHASED AFTER 1979, RENTS IN EFFECT ON THE DATE OF PURCHASE YIELDED FAIR RETURN.

The theoretical value of a rental property is often estimated in terms of the rents it yields. In its Statement of Decision the Trial Court cites from a real estate text the definitions of technical terms such as "capitalization rate" and "gross income multiplier" which are used for that purpose. But, as stated in the cited text, this is a "general rule of thumb which varies with specific properties and areas" (at p. 3, fn.1, 7 JA 119 at p. 2141). The actual price paid for a rental property, at any time, let alone under extreme rent control, depends on many factors, not necessarily related to rates of return instantly available in other investment.

Throughout the period of rent control many properties in Berkeley have had a negative cash flow. That would make their value, on the "capitalization" measure, less than zero. Yet those properties were sold and there is no reason to believe that the seller paid money to the buyer to take the property off his hands. However, had that happened, had the buyer paid nothing for the property, or had he actually got money to take over the ownership of the property, the tenants would, under the Trial Court's line of reasoning, be entitled to live rent free forever, or even to get a share of the payment the buyer received, because otherwise, Lord forbid, the buyer would be getting a windfall.

In real life, the price paid for a piece of property is affected by many different variables. One of them is the fact that whereas some investors seek immediate return, long term investors evaluate the future prospects of the property and some are prepared to accept poor return, or even losses, in the interim. It is good social policy to attract long term investors into the housing market, because they bring stability. But the Trial Court's decision would actually penalize them. It is certain that absolutely no short term profit seekers invested in Berkeley rental property after 1979. For long term investors, the reasonable expectation that an attractive city like Berkeley cannot forever have rent levels hugely below the rent levels of the surrounding communities affected the prices paid. Therefore the presumption that Berkeley properties purchased after 1979, had rents which yielded fair return at the time of purchase is unwarranted.

Even in the absence of rent control, some rental properties may not yield fair return. That is common during periods when the supply of rental housing exceeds demand. In order to assure full occupancy, owners may charge lower rents than the quality of their units would justify, and accept poor return, in the expectation that when demand catches up they will be able to raise rents and obtain fair return. Such was evidently the situation in the case of Levin-Zemel Inc. v. City of Berkeley Rent Stabilization Board, No. 598234-3 which Judge Sutter decided in 1986, and portions of which he attached to his Tentative

Decision herein. In his Ruling on Petition for Writ of Mandate in the Levin-Zemel case, the Judge cited the following fact from the Rent Board opinion: "Over the next 15-year period the property produced a negative cash flow of \$2,000-\$3,000 annually depending on the expenses incurred." (Levin-Zemel, Ruling on Petition for Writ of Mandate, p.3. A copy of pertinent pages is attached hereto as Exhibit A). There rent control trapped the owner in a situation which he got into because he thought it would be only temporary. In that case Judge Sutter ordered the Board to remedy the situation. (Ibid, p. 25) But in the instant case the same Judge makes a presumption that would trap all post 1979 purchasers in the same sort of a bind.

It does not help that the presumption is rebuttable. In the case of across the board regulations, it is a big mistake to set up the untypical case as the presumed norm, because then all the typical cases would be forced into individual adjustment petitions, resulting in enormous administrative delays and thus in a violation of Birkenfeld v. City of Berkeley, (1976) 17 C.2d 129, which requires reasonably prompt relief.

Furthermore, it is not clear how a post 1979 purchaser could make a showing sufficient to rebut the presumption. If he paid more for the property than the rents in effect at the time of purchase warranted, he is likely to be told that he should have foreseen that the existing rents would not give him fair return, and "cannot expect the Rent Board or the courts to remake a bad

bargain."¹ If on the other hand he got the property cheap, he will be denied the benefit of his bargain, because a rent raise would give him a "windfall". In either case the tenants and their successors will forever enjoy rent levels well below those of other Berkeley tenants, for no reason except that the building happened to have been sold during the period of extreme rent control.

II. THE BASIC STANDARD FOR SETTING MAXIMUM RENTS UNDER THE BERKELEY ORDINANCE IS THE MAINTENANCE OF NET OPERATING INCOME (MNOI) STANDARD, WHICH RESTS ON THE PRESUMPTION THAT BASE YEAR RENTS YIELDED FAIR RETURN.

There are many possible ways a rent control ordinance can set maximum rents, and most of them have been tried. As the California Supreme Court observed in Fisher v. City of Berkeley, (1984) 37 Cal.3d 644, "For more than a decade, rent control agencies throughout the state and the nation have employed a veritable smorgasbord of administrative standards by which to determine rent ceilings". (at pp. 679-680; citations omitted) Currently, the most widely used is the "maintenance of net operating income" (MNOI) standard, which rests on the presumption that rents in effect at a particular date, typically just prior to the establishment of rent control, yielded a net operating income which constituted "fair return". Subsequent rent increases are allowed only to maintain this fair return.

¹ Searle v. City of Berkeley Rent Stabilization Board (1988) 197 Cal.App.3d 1251, 1258, hereinafter referred to as Searle I.

The problem with this standard is that the presumption of fair return in the base year may not be correct. This presumption is of course rebuttable, but under the Berkeley system, it was initially rebuttable only under a very narrow set of circumstances and Judge Sutter railed against that narrowness in Levin-Zemel. This problem was finally resolved in Vega v. City of West Hollywood (1990) 223 Cal.App.3d 1342. The Vega Court states: "When base date rents can be adjusted to reflect prevailing rents for comparable units, everyone within the ambit of the rent control scheme participates on an equal footing" (at p. 1349, emphasis added)² In Berkeley, the previously unfair situation was corrected, and everyone was put on an equal footing, by the adoption of the "historically low rent" and "comparable rent" regulations (i.e. regulations 1280 and 1262(C)(3)). These very correctives were among the targets of the instant litigation. Judge Sutter, very soundly, upheld them, but weakened their benefit by reintroducing inequalities for post 1979 purchasers.

Another problem, not endemic to the MNOI standard as such, arose from the way the system was applied in cities such as Cotati and Berkeley. In those cities rents were raised only to compensate the landlords for increased expenses. The NOI was maintained only at the base year dollar amount, and was therefore continually eroded by inflation. This was corrected in Cotati

² This language is cited with approval by Judge Sutter in his Tentative Decision (at p.19, 6 JA 104 at 2037)

after the decision in Cotati Alliance for Better Housing v. City of Cotati (1983) 148 Cal.App.3d 280 and in Berkeley after the decision in Searle II. The so-called "Searle regulations", which corrected this defect were attacked in the instant litigation. The Trial Judge upheld these regulations, but by restricting indexing for post 1979 purchasers, reintroduced, for them, the old inequities.

The regulations challenged in this litigation, far from being defective in any way, have made the Berkeley MNOI system rational and just.

III. THE MNOI STANDARD FOR SETTING MAXIMUM RENTS IS SUPERIOR TO OTHER STANDARDS AND IS THE ONE MOST WIDELY USED.

War time rent controls, which simply froze rents, made no attempt to balance the interests of tenants against the interests of landlords.³ Those controls were adopted only as temporary emergency measures.⁴ But when rent control started developing into an ongoing regulatory system, it became apparent that excessively low rents caused lack of upkeep, deterioration of

³ But even in war time it was felt that some rent raises should in fairness be allowed. Rethinking Rent Control: An Analysis of "Fair Return" (Scott J. Shelton) 12 Rutgers Law Journal 617, 618 fn. 13.

⁴ Consequently most old cases discuss at length whether an "emergency" persists which justifies rent control. A relic of this approach are the statements in the preambles to most ordinances, including the Berkeley ordinance, to the effect that a housing emergency exists.

rental housing stock, abandonment of properties by owners, and flight of private capital from investment in residential properties. It became therefore imperative to balance the interests of low income tenants in the availability of decent affordable rental housing against the interests of landlords in reasonable income, so that private investment in rental housing would be encouraged.⁵ Thus the Cotati court emphasized the "[s]ocietal importance of ensuring that real estate remains a viable investment so that the rental housing stock is maintained, improved and replenished." (supra, at p. 295) Many different ways of achieving this goal were discussed by the courts. Providing "fair return" to the landlord came to be seen as essential. The phrase "fair return", was often used interchangeably with "just and reasonable return", "fair return on value", or "fair return on investment". On analogy with old railroad cases and public utility cases, "fair return" came to be established as a prerequisite for the constitutionality of rent control ordinances. Unfortunately, defining "fair return" has proved to be a very difficult task.

1. The fair return on "value" standard is defective.

At first the favorite interpretation of "fair return" was

⁵ Federal, State and local governments can and should, of course, help to provide affordable housing for low income people. But "rent control" as such is concerned only with restrictions on the rents private owners can charge to all their tenants, whether the tenants are rich or poor.

"fair return on the value of the property ". In Troy Hills Village v. Township Council (1975) 68 N.J. 604, 350 A2d 34, which is usually cited as the chief authority for this standard, the Supreme Court of New Jersey grappled valiantly with the difficulties of finding a proper determinant of value which is neither circular nor skewed by special circumstances. The Troy Hills court opted for an English model, where "'value' refers to the worth of the property in the context of a hypothetical market in which the supply of available rental housing is just adequate to meet the needs of the various categories of persons actively desiring to rent apartments in the municipality." (at p. 44) This standard was soon found, by the same court, to be "practically unworkable". (Helmsley v. Borough of Fort Lee, (1978) 392 A.2d 65,72.)

Other measures of "value" have been found to have other difficulties. Where value is determined by rents, it is circular to attempt to determine rents by value, as has been pointed out in Cotati Alliance for Better Housing v. City of Cotati, *supra*, p. 187). Measures such as "assessed value" or "sale price of comparable properties" will likewise be circular in cases where these values are a function of rents. Old yardsticks such as "cost of construction" may be too remote and inappropriate, while "cost of replacement", a concept borrowed from insurance, would most likely raise rents well above market levels, thus defeating the whole purpose of rent control.

Yet as recently as the Fisher litigation, the landlords who

there challenged the Berkeley Ordinance on its face, claimed that they were entitled to fair return on the "value" of their properties. In this they relied on the wording in older cases, incautiously echoed in more recent cases such as Birkenfeld v. City of Berkeley (supra, at p. 165). The Supreme Court in Fisher described its "return on value" language in Birkenfeld as a dictum, (Fisher, supra, p. 681, fn.35) and roundly rejected the value standard as circular, (ibid., pp. 680-681, fn.33) citing Cotati and other cases and texts.

2. The fair return on "investment" standard is even more defective.

Fisher as well as Cotati have endorsed, on its face, the fair return on investment standard enunciated in the Cotati and Berkeley ordinances⁶. On its face, the concept of "fair return on investment" does sound intuitively fair and reasonable. On closer analysis however it turns out to be fatally vague and unworkable.

(a) All hitherto proposed definitions of "investment" lead to inequities.

It is not easy to determine what exactly constitutes investment. Is it just the original cash outlay, or should post-purchase payments towards principal be also counted as investment? Should the owner's physical labors and expenses for

⁶ Both the Cotati and the Berkeley Ordinance have always employed the MNOI standard for annual general adjustments. But they each also had, as a fallback position, a vaguely phrased provision which purports to guarantee "fair return on investment" to landlords, in the event that the other provisions fail to give them this constitutional requisite.

capital improvements be included? The courts in both Fisher (at p. 685) and Cotati (at pp. 289-290) accept these additions to "investment". And, indeed, if "investment" is our basis for "fair return" then the total investment should certainly be counted. To exclude these components of investment would be unfair,⁷ but including them will make the system unworkable. Not only are capital improvements made frequently, but additions to principal are made every single month. And these additional investments are different for every single landlord. Furthermore, the additions to principal change over time, e.g. they become an increasing portion of debt service payments, as the balance due, and thus interest due, decrease. Calculating all of these each year for each owner would be a daunting task.

Another problem is presented by properties obtained without any investment whatever, e.g. by gift or inheritance. The conventionally proposed solution is that the donor's investment be transferred to the recipient. (Fisher p. 685, Cotati, p. 289). But the donor's long ago investment, plus his payments on principal, and his labors and expenses on capital improvements over the decades, may be impossible to ascertain. And the appraisal of the donor's property for probate or tax purposes will have been made in terms of the property's "value" which, for

⁷ Some New Jersey jurisdictions do count only the original cash investment, and this has been held constitutional, by a New Jersey trial court, provided the original investment is indexed for inflation. (Baar, Guidelines for Drafting Rent Control Laws: Lessons of a Decade (1983) 35 Rutgers L. J., pp. 794-795) This scheme is vulnerable to legal challenge.

the purpose of setting rent ceilings, is a discredited yardstick.

A particularly difficult problem for a definition of "investment" is presented by the buyer who purchased the property with no downpayment, or who, through re-financing, or because of an unexpected drop in property values, ends up having negative equity. Should he receive negative rent? Judge Sutter, in discussing the issue of mortgages, has displayed an acute awareness that some owners are highly leveraged, (Tentative Decision p.8, 6 JA 104 at 2026) and that a failure to make mortgage payments can lead to bankruptcy and to a tax disaster. (Tentative Decision, p.6, 6 JA 104 at 2024). But he appears to have overlooked these points when he inserted the "return on investment" standard into the Berkeley MNOI system. The "investment" of the owner with negative equity is his exposure to risk, but how can this investment be measured?

The opposite situation, where the landlord owns the property "free and clear", would justify higher rents than properties in which the landlord made a much smaller investment. This would encourage owners to borrow money on their other assets and buy their rental property with cash to maximize rents.

Another problem arises, where it is the total purchase price that is considered as the "investment" which is to yield the "fair return". This appears to be the situation envisaged by the Trial Court's hypothetical examples⁸ on pp. 14-15 of the

⁸ Incidentally, the hypotheticals only support the Judge's position, because they explicitly postulate what he assumes, namely that the rents in effect at the time of purchase

Tentative Decision. (6 JA 104 at 2032-2033) But, unless the property was bought with all cash, it is not the case that the total purchase price was invested. The purchase price may not be paid in full for thirty years! The total price definition of investment is more akin to the disgraced "value" concept than to the "investment" concept.

It is sometimes claimed, in rent control cases, that the investment made, was excessive. But, if the investment has indeed been made, and current rents do not yield fair return, then rents should be raised. But if rents have to be raised to yield fair return, then the investment may be deemed excessive simply on the grounds that existing rents do not yield fair return on the investment. This produces a circularity as bad as that under the "value" measure of "fair return".

The inevitable fact is that different owners will have made vastly different investments in what are very similar properties. Some sellers are shrewder than the buyers, and vice versa. Older people buy with cash and look to steady income. Younger buyers, confidently expecting increasing future income from all sorts of sources, have no fear of high leveraging. At some times credit is harder to obtain than at other times, and interest rates are in constant flux. All of these are problems facing investors, who have to make their decisions whether to buy or sell and at what terms. These problems should not be faced by tenants, who have no say in the decisions.

immediatly yielded fair return on the price paid.

It makes market sense, and is only fair, that comparable units should have comparable rents. But the return on investment standard, seriously applied, would lead to anomalous disparities in rents for similar units. It may be, as the Fisher court states, (at p.689, citing Cotati) that such disparities are not necessarily unconstitutional, but neither are they desirable. Comparable rents for comparable units are desirable, and are not unconstitutional either.

(b) "Return" is not a clearly defined notion.

Assuming that we could somehow develop a workable definition of "investment", how shall we determine what all constitutes a return? Tax savings are usually listed as part of the owner's return and this, on its face, has been approved by the courts, (Cotati, p.295, Fisher, p.689, fn.46) but no guidelines are given. Since the tax situation of each owner is different and changes over time, and since the tax law itself is subject to constant change, it is hard to see how this part of the return could be evaluated. Furthermore, tax savings are recaptured by the IRS from the owner when he sells the property. How could he in turn recapture from the tenants past diminutions of his return caused by his temporary tax saving?

There is also a psychological factor to ownership: what real estate people call the "pride of ownership". If a landlord derives gratification from owning a nice building full of nice tenants, does that constitute a part of the "return" on his investment, such that he should reduce his rents on that account?

And how about a landlord in a high crime area, in and around whose building, because of drug trade and shootouts, police make frequent interventions. Does his shame and distress reduce the "return" he receives on his investment, justifying rent raises?

(c) There is no satisfactory criterion as to what kind of return is "fair".

Even if "return" were defined satisfactorily, what would constitute a "fair" return? Two percent, five percent, ten percent of investment annually, or what? Ordinances and court decisions list numerous factors that should be weighed when determining whether a return is "fair". The Cotati court notes that investment in rental property "which involves risk as well as active management and which usually involves anguish and worry on the part of the investor" should "bear a greater rate of return than a passive investment ... e.g. an insured certificate of deposit with a financial institution." (at p. 295). This is correct, but by how much should the landlord's rate of return be greater? Besides, as the Rent Board's consultants point out in their report entitled: "Defining 'Fair Rate of Return' in Berkeley Rent Regulation in the Aftermath of the Searle Decision" (AR 443B) interest rates on financial instruments fluctuate over time, and if rents were closely tied to that, it could "create fluctuations in rents that may be considered undesirable as a matter of social policy." (AR 443B p.27)

The Cotati Court notes that "some buildings have types of tenants who create more psychological and management hardship to

the owner than others." (at p.295)⁹ These are very sound observations, but it would be hard to determine objectively just how big a rent increase these factors would justify.¹⁰

In short, on close analysis it appears that the "fair return on investment" standard, though it sounded good at first blush, is even less workable than the "fair return on value" standard.

3. The MNOI standard of fair return provides stability, and makes it easy to set rents. As reformed in Berkeley, the standard is fair. It is by far the most frequently used standard today.

By comparison with the other standards the MNOI standard is much easier to use and is fairer as well.

One advantage of the MNOI standard is that rents become stabilized. This is why the Berkeley Ordinance, like most modern ordinances, is proudly called "Rent Stabilization Ordinance". Under this system rents are not allowed to jump up when the property is sold or refinanced,¹¹ and are completely independent of how high or how low a price particular owners may have paid

⁹ The psychological factor will resonate with any landlord. It could, also, singlehandedly destroy rent control. Since the stresses of owning rental property in a rent controlled jurisdiction are so much greater than in a free jurisdiction, they would justify a much higher than free market return.

¹⁰ One writer considers the Cotati criteria too subjective, and likely to lead to courtroom contests among economists evaluating rates of return and psychiatrists evaluating stress. (Baar, supra, at p.796.)

¹¹ The Supreme Court in Fisher particularly appreciates these "antispeculation" provisions. (at p.691-692)

for the property, or what kind of financing they obtained. It is always within the power of buyers and owners to structure the sale price, the downpayment, and the terms of financing or refinancing. The MNOI system, as distinct from the "investment" system, eliminates incentives to structure such factors so as to maximize rents.

Another advantage is that rent ceilings can be calculated with precision. Base year rents, comparable rents, increases in the consumer price index, etc. can be easily ascertained. Thus landlords, tenants and the regulatory agency can deal with hard figures, instead of floundering among vague concepts such as what really constitutes "value", what counts as "investment", or what might be a "fair return".

The presumption that base year rents yielded fair return, is reasonable, as long as it is rebuttable under circumstances such as are outlined in Vega (supra) and such as are embodied in the regulations challenged in this litigation. Thus comparable rents for comparable properties are achieved, eliminating the usual inequities and anomalies which plague other systems.

In Berkeley, the annual general rent adjustments (AGAs) now include not only increases in landlords' expenses, but also full indexing of the base year NOI for inflation, under Regulation 1100. The failure to include such indexing during the previous decade was corrected by Regulation 1113, phased in pursuant to

Regulation 1274.¹² The Berkeley Rent Stabilization Board adopted these regulations to comply with the commands of Searle II. These regulations have made the Berkeley MNOI system rational and fair.

The 1983 article by Baar reports that at that time the MNOI standard was used in 60% of the rent controlled units nationwide. The so-called "return on value" standard, the next most popular, was used in only 15% of units, mostly in older jurisdictions in the East. The "return on investment" standard, in various versions, was third with 7% of units, likewise in the East, followed by smaller percentages of other assorted standards. (Baar, supra, p. 785, table 7.3) Most of the more recently adopted ordinances use the MNOI standard. This standard is thus not only superior to the others, but is also the one most used.

What draws us to the other standards, before we start thinking about the matter seriously, is the compellingly attractive sound of the expression "fair return". But it is a siren sound that leads to trouble as soon as we attempt to determine what the "return" is supposed to be a return on. It would be best if we would change the expression to "fair income".

¹² For low income tenants the rent increases under this so-called "Searle regulation" are phased in over 3 years.

IV. THE TRIAL COURT'S INSERTION OF AN "INVESTMENT" STANDARD INTO THE BERKELEY MNOI SYSTEM WOULD DENY DUE PROCESS AND EQUAL PROTECTION TO NEW LANDLORDS, AND WOULD RESULT IN DISPARATE RENTS FOR COMPARABLE UNITS.

1. Berkeley's old, vague "fair return" provision shielded the system from facial challenge, but was not workable. In practice, "fair return" was defined as maintenance of base year NOI.

The Berkeley Ordinance has a provision (section 12(i)) which states: "[n]o provision of this Ordinance shall be applied so as to prohibit the Board from granting an individual rent adjustment that is demonstrated necessary by the landlord to provide the landlord with a fair return on investment." This provision is a perfectly drafted shield against any facial attack on the Ordinance. Even when landlords were able to demonstrate convincingly that certain provisions could lead to unconstitutional results, this fall-back provision kept them all in place. The Supreme Court in Fisher praised this provision as a "safety valve" which "overrides all other provisions of the ordinance" (at p. 692).¹³

It didn't matter that the Ordinance did not contain any clear definition of what constitutes "fair return on investment", except for providing a listing of vague general factors. The Fisher Court noted with approval that "these factors are expressly nonexclusive" and permit "the Board to consider 'all relevant factors' in determining the 'landlord's rate of return on investment'." (at p. 684, fn. 40) In a facial challenge, the

¹³ A similar provision provided an effective shield in Cotati.

courts "will declare the adjustment procedures invalid only if the ordinance on its face will not permit the Board to avoid" unconstitutional results. (Fisher, p.687) And, on its face, the "fair return" provision of the Ordinance made it appear that the Berkeley Rent Board could avoid unconstitutional results.

The "fair return" Regulation (1275) in effect at the time of the Fisher case¹⁴ included the following provision:

"until such time as the Board adopts regulations setting forth specific guidelines to be used in determining the rent ceiling level for unit(s) which would provide the landlord with a fair return on investment based on equity or property value, the rent ceiling level necessary to provide a fair return on investment shall be calculated according to Sections 1262-1274 of the Board's regulations.

What was provided for in those sections is a complete freezing of the 1979 NOI at the 1979 dollar amount. It appears that the Fisher court was aware of that, but expected the Board to set forth specific guidelines soon. Regulation 1275 was amended in 1987, to include a long list of factors, including inflation, to be considered in determining "fair return"; but again no guidelines were provided.

The issue was squarely faced by this Court in Searle II, where regulations applied to these Amici were challenged. This Court was the first court ever to take note of the vagueness of the "fair return" regulation. It ordered the Board to "establish guidelines as to what constitutes a fair return on investment so that landlords may make informed decisions whether to petition for an increase in rents on the basis they do not receive a fair

¹⁴ A copy of that Regulation is enclosed as Exhibit B

return on their investment." (slip opinion, p.1)

Until that was done, the vague general wording, though providing a good shield in court, was totally useless as a tool for actually adjusting rents. Consequently in actual individual adjustments the Rent Board resorted to its basic MNOI standard. From 1980 to 1987, "fair return" was defined as maintenance of the dollar amount of the base year NOI. When 40% indexing was introduced in 1987, "fair return" was deemed to be the maintenance of the base year NOI indexed by 40% of the CPI increase.

Both these phases of interpretation are illustrated in the Rent Board stages of Searle II. These Amici, who purchased their building in 1984, petitioned in 1986 for "fair return". In his first Decision, in November 1986, the Hearing Examiner stated:

As the NOI method is the means authorized by the Rent Board to provide landlords with a fair return on their investment as required by the Ordinance, Petitioners' request for an increase to provide fair return will be considered the same as the request for an NOI increase. In the absence of a Board regulation permitting indexing, an increase for NOI based on an inflation index is not allowed. Therefore, Petitioners' request for an indexed base year NOI is denied. (Searle II, Joint Appendix, Vol.I, pp.34-35)

The final decision in that matter was made by the Rent Board in March 1988, when the 40% indexing regulation was in effect. The Board stated:

Landlords also appeal the Hearing Examiner's refusal to consider their request for retroactive¹⁵ indexing of NOI. Regulation 1264 grants landlords the right to petition for

¹⁵ This language should not mislead, "prospective" rent increases were sought.

retroactive indexing of their base year NOI to reflect 40% of the increase in the consumer price index since May, 1980. The Regulation will be applied to insure that a landlord is receiving a fair return on the property. We therefore find that the landlord is entitled to indexing in the instant case. (Searle II, Joint Appendix, Vol.I, pp.134-135)

In both decisions, what constituted "fair return" for these Amici, was defined in terms of the net operating income which the property yielded to the previous owner in the year 1979.

The general wording of the "fair return" provision, which has been confusing landlords and misleading courts for years, was not in fact used. In practice, "fair return" was interpreted as maintenance of the base year NOI, regardless of whether the property changed hands since the base year.

There is nothing wrong in this approach. In view of the severe problems inevitably encountered when one really tries to make e.g. the "fair return on investment" standard work, it is no wonder that the Rent Board extended to the "fair return", used in individual adjustments, the same MNOI standard which it has always used in annual general rent adjustments.¹⁶ But where that is the practice, the "fair return" regulation should honestly reflect what rule is in fact being followed. This was done when the Board fully complied with the Court Orders of Searle II and adopted the new Regulation 1264.

¹⁶ Besides, the Board's consultant strongly recommended the MNOI standard of fair return over all other standards. (Searle II, Joint Appendix, Vol.II, pp.52-53.)

2. In Compliance with Searle II the Rent Board adopted rationally based indexing regulations and an unambiguous "fair return" regulation, all of which define "fair return" as maintenance of a fully indexed base year NOI.

This Court ordered the Board in Searle II to adopt rationally based indexing regulations. To comply, the Board retained consultants who in their report, entitled "Inflation Indexing in Berkeley Rent Regulation in the Aftermath of the Searle Decision", strongly recommended (AR 92B, esp. at pp.49 and 82) that base year NOIs be indexed at 100% of the CPI increase. The Board, after considering this input, as well as input from many other sources, adopted the so-called "Searle regulations", which do provide such indexing.

To comply with this Court's order to adopt a clear "fair return" regulation, the Board obtained from its consultants a report on "Defining Fair Rate of Return" (supra, AR 443B). This report noted that rent control schemes which do include a "fair return" provision,¹⁷ either couch it in a very vague language, or else define fair return in terms of maintenance of base year NOI. (AR 443B pp.11-14) The consultants recommended that, to comply with Searle II, the "fair return" regulation be drafted in line with the basic MNOI scheme. (AR 443B p.56) The Rent Board's new Regulation 1264 is in fact formulated along those lines. (A copy

17 This Report also noted that some systems have no "fair return" provision as such at all. These generally are systems with vacancy decontrol, which remedies any inequities over time, so that "fair return" need not be sought through administrative proceedings. Thus San Francisco had no "fair return" provision until it instituted vacancy control in 1991. (AR 443B pp. 10-11) Berkeley has full vacancy control.

of its newest revised version is attached hereto, marked "Exhibit C.") The system was thus made clear and consistent.

3. The Trial Court's insertion of an "investment" standard into the MNOI system would result in disparate rents for comparable units and would violate Vega.

Under the Trial Court's Decision, properties purchased in 1979 or before, will continue to be governed by the presumption that they yielded fair return in 1979 and therefore their NOIs will be indexed from 1979. On the other hand, properties purchased after 1979, will be governed by the presumption that they yielded fair return to their owners on the day of purchase, and therefore will receive indexing only from the date of purchase. There is no rational basis for classifying Berkeley properties along these lines. As a result of this unequal treatment, comparable apartments in Berkeley will have vastly different rents, depending on when the current owner purchased the property. The later the date of purchase, the cheaper the rent, regardless of the quality of the apartment. This is not a rational outcome.

Moreover, this outcome violates Vega v. City of West Hollywood (supra), which strives to achieve comparable rents for comparable units. The West Hollywood rent control system, reviewed in Vega, is, just like the Berkeley system, based on the MNOI standard. It presumes "that the net operating income produced by the property during the base year provided a fair return (fair net operating income)." (Vega, supra, p.1345, fn.1).

Whereas the Vega Court attempted to cure the inequities of wildly disparate rents for comparable apartments, the Trial Court herein, by injecting an incompatible presumption into the Berkeley MNOI system, would generate disparate rents and resulting inequities.

4. The establishment of a different "fair return" standard for post 1979 buyers would deny them equal protection and would perpetuate the freeze that had been found in Searle II to be a denial of due process. The Trial Court overlooks that the MNOI system can be a measure of fair return.

Net operating incomes in Berkeley have been frozed at their 1979 dollar level until the Regulation 1113 became effective in November 1991. This freeze, which denied due process to Berkeley landlords, has been thus remedied. The Trial Court's proposal however would perpetuate the freeze indefinitely for post 1979 purchasers.

This different treatment of post 1979 purchasers denies them equal protection. Earlier purchasers, regardless of the price they paid, or the downpayment they made, etc., need not submit to burdensome individual adjustment proceedings to obtain indexing from 1979. The inevitable delays involved in such proceedings for all the post 1979 purchasers, would undoubtedly violate the Birkenfeld requirement of reasonably prompt relief.

Furthermore, even when these purchasers demonstrate that, in the expectation that fair return would be received in the future, they paid more for the property than the rents received at the time would justify in a free market, they are likely to be denied

relief on the grounds stated in Searle I (at 1258, see ante p.6). Therefore the post 1979 purchasers will never be able to rebut the unjustified presumption of the Trial Court, that for them the rents at the date of purchase yielded "fair return", and will forever be shortchanged, in violation of Searle II.

The Trial Court appears to have failed to appreciate the complexities of what might constitute "investment", "return" etc. etc., which were discussed above in this brief. The Trial Court seems to consider it a simple task to frame regulations which provide fair return on investment to landlords whose purchase price was higher than the rents in effect at the time of purchase would justify in a free jurisdiction. However, as the Board has for over a decade failed to come up with anything other than the MNOI measure of fair return, it is unlikely that it can come up with anything else now. Besides, the experts agree that the MNOI system is the best, and keep recommending it to the Board.

The Berkeley property market was skewed by rent control and threats of rent control long before 1979. The Birkenfeld case (supra), decided in 1976, invalidated a 1972 Berkeley Charter Amendment,¹⁸ which had established a rent control scheme more defective than the one in effect since 1980. Other rent control measures were enacted in the late seventies.¹⁹ There is therefore

¹⁸ A copy of this Amendment follows the Birkenfeld decision at p.174.

¹⁹ The "Renter Property Tax Relief Ordinance" of 1978, a copy of which is attached as Exhibit A to Appellants' Reply Brief in Searle II., and the Temporary Rent Stabilization Program of 1979.

no rational basis for treating post 1979 purchasers differently from 1979 purchasers and pre 1979 purchasers.

5. The Trial Court's proposed rollback of rents would hurt post 1979 purchasers, particularly recent ones, more than Measures E and H which were rejected by Berkeley voters, and more than the old 40% indexing, rejected in Searle II.

The rent rollback proposed by the Trial Court would affect different post 1979 purchasers differently, depending on when they bought their properties. 1980 purchasers would have only a small rent rollback, whereas 1990 purchasers would have a big one. People who purchased their properties when the "Searle regulations" were fully in effect would have no rollback at all.

People who purchased their rental properties between the mid eighties and the actual effectiveness of the "Searle regulations" would be deprived of all indexing in the years when inflation was highest. They would have fared better under the 40% indexing regulation, invalidated in Searle II, which would have given them 40% indexing from 1980.

In 1992, two Measures were before the Berkeley voters, each dubbed "Searle rent rollback".²⁰ One was Measure E proposed in the primary election in June and the other, Measure H, proposed in the general election in November. Both proposed that the 28% Searle rent increase be reduced to 9% prospectively. The voters

²⁰ Plaintiff City of Berkeley was very active in promoting the passage of these Measures, as it had been active in other attempts to destroy the impact of Searle II. It unsuccessfully attempted to intervene in Searle II after the Writ of Mandate was returned, and in the instant action made the unsuccessful Motion that any mention of Searle II be stricken from all pleadings.

in Berkeley rejected both Measures. Had the measures passed, most recent purchasers would have been better off than under what the Trial Court proposes.

6. The Trial Court's proposal that sales data be studied would produce no usable data for setting rents. The MNOI system for good reasons rejects sales figures, it does not speculate about them.

The Statement of Decision proposes that sales data be studied and interpreted to see what post 1979 purchasers paid. (at pp. 3-4, 7JA 199 at pp.2141-2142) It states: "The task of examining and interpreting sales data is not simple but it is not impossible either." (p.3, ibid. 2141) This may be so, but the sales data will vary over time, depending on many factors, one of which is the rising and sinking hopes, as to when rents in Berkeley will go up. What is the Board to do with these disparate data when it gets them? Let us say that one buyer got a good price and another buyer paid a lot more, or that buyers in one year got a good price and in another year paid more. If their indexing starts from the date of purchase, how is it to be modified for the buyer who paid little and how is it to be modified for the buyer who paid a lot?

In its Statement of Decision the Court states: "The point is that the Board's regulations on categories of buyers should be based on evidence, not speculation or rhetoric." (at p.4, 7JA 119 at 2142) But the MNOI system is based on neither speculation nor rhetoric about the circumstances of various buyers. The MNOI system is specifically designed to avoid collecting sales data,

interpreting them, or figuring out how to base some sort of even handed fair return measure on them. The only place where speculation and rhetoric might occur, is in discussions as to what the Trial Judge's proposal might involve and how it might be fitted in.

7. Nothing in Searle I supports a different fair return standard for post 1979 purchasers.

The Trial Court states that fair return "refers to the landlord's investment not that of some prior owner." (Tentative Decision p. 11, 6JA 104 at 2029) This is in error. In the context of the Berkeley Rent Stabilization Ordinance, it should be remembered that "the ordinance defines 'landlord' ... to include 'successor' Even if the term were ambiguous, the Board's interpretation is entitled to great weight and must be upheld if it has a reasonable basis." (citation omitted) Searle I, at p. 1255.

The Trial Court, of course, may take the position that here that interpretation does not have reasonable basis, because, as the Trial Court argues, "permitting rent increases where none is required to provide a 'fair return on investment' by any reasonable interpretation of that phrase is unwarranted." (Tentative Decision, p. 12, 6JA 104 at 2030) The Court goes astray in clinging to an old interpretation of "fair return" which simply does not envisage an interpretation of that phrase in terms of MNOI. But the MNOI interpretation is perfectly reasonable, and for sound reasons, outlined above in this brief, it does not concern itself with the actual "investment" of

individual owners. Unfortunately, the language of "fair return on investment" remains lodged in many ordinances, regulations and court opinions, thus confusing everybody. The MNOI measure of "fair return", as shown above, is superior to other measures. That is the reason why MNOI has become the prevailing standard in recent decades.

The Trial Court in its Tentative Decision on pp. 11-12 (6JA 104 at 2029-2030) cites a phrase from Searle I, which it evidently believes supports its position. However, that phrase is taken out of context. A larger portion of the passage reads as follows:

... even if the Board's interpretation of section 11.h. were designed to depress the price of unregistered property and even if this were the result in this case (which Landlords have not alleged), and even if this constituted an unreasonable and oppressive penalty, it would punish sellers, not buyers of unregistered property. Thus, these Landlords lack standing to challenge this alleged penalty from which they have "neither suffered nor are about to suffer any injury." (Searle I, at p. 1256)

This Court was saying that if the regulation depressed the sale price, the seller had standing to challenge the regulation, not these Amici, who were the buyers. But such situation was only theoretically considered, "not alleged", and this passage has no bearing on when indexing should commence for post 1979 buyers.

As this court well knows, Searle I concerned the old and unique Berkeley provision²¹ which extended the penalty for non-

²¹ Only two other California rent control jurisdictions have such a provision, but each restores the lost AGAs to the unregistered owner after registration. (Santa Monica Ordinance, Section 3002(d) and West Hollywood Ordinance, Section 6407.D)

registration, namely loss of AGAs, to landlords, like these Amici, who purchased the property and immediately registered it. After Searle I, the California legislature passed Civil Code Section 1947.7, which provides that a landlord who comes into compliance with a rent control ordinance, may be granted prospectively any rent adjustments lost because of prior non-compliance. (a copy is attached as Exhibit D) This law is reflected in Berkeley Rent Regulations 1278 and 1278.5. (copies are attached as Exhibits E and F).

Judge Sutter quotes correctly from Searle I the passage where this court cites from that trial judge the following; "'the real issue is ... the price you paid for the property, so it relates to your fair return' and 'that issue should first be handled through the administrative agency.'" Searle I, p.1257. What this passage demonstrates is that at that time both that trial court and this Court believed that other administrative remedies, not yet exhausted, would provide proper relief. As this Court stated, "if Landlords are not receiving a fair return on their investment, they should be allowed to increase rents via an IRA petition to obtain fair return." (ibid. at p.1258)

In vain did these Amici protest that the IRA process as it existed in Berkeley considered the sale price as irrelevant and only considered landlord's expenses. The trial court pointed out: "If they had done that in your case, then I would have a record before me that would be meaningful for me to consider" (Searle I, Reporter's Transcript p.11). In short, our

protestations about the IRA process were premature.

The IRA process came under scrutiny in Searle II. But the features scrutinized were limited to the irrationality of the indexing scheme, and the vagueness of the fair return regulation. The merits or demerits of the MNOI concept of fair return, as opposed to the return on investment concept, were not addressed.

The use of the MNOI concept in indexing was clearly presupposed by both these Amici, by the Respondent Board, as well as by this Court. Since MNOI was taken for granted, it was neither briefed by the parties, nor discussed by this Court. But from the fact that the Court and the parties were silent on the issue, it should not be inferred, as the Trial Court appears to do here, that the parties or this Court overlooked something. Indexing of the 1979 NOI from 1979 was ordered for all landlords, including these Amici, who were known to have purchased their property in 1984. However, the possibility that different criteria could be formulated for the "fair return" regulation was also clearly contemplated by all concerned.

Judge Sutter has precipitated this discussion as to whether MNOI can provide fair return, by insisting that for post 1979 purchasers, indexing from 1979 was not required "by any reasonable interpretation" of "fair return on investment". (at p.12 of Tentative Decision, 6JA 104 at 2030)

V. NO COURT TO DATE HAS ADDRESSED THE MNOI AS MEASURE OF FAIR RETURN, BECAUSE SO FAR THE ISSUE HAS NOT BEEN PRESENTED.

Never before this instant case have the courts been fully briefed on the MNOI system. The Fisher Court was aware of the fact that in annual general rent adjustments Berkeley uses the MNOI standard (at 679, fn. 32), and worried that prolonged failure to index the landlords' base year NOI would result in confiscation. (at p.684). But the Fisher Court was mainly concentrating on whether the back-up standard contained in the ordinance, namely the vaguely worded "fair return" provision, provided an adequate shield against the various features of the ordinance, which were being challenged on their face.

In Searle II, this Court found that a fair return regulation, which fails to establish guidelines as to what constitutes fair return, violates due process, and ordered the Board to establish such guidelines. But this Court did not order the Board to establish any particular guidelines, leaving this matter to the Board's discretion.

VI. IN PRESCRIBING A PARTICULAR MEASURE OF FAIR RETURN, THE TRIAL COURT HAS ENCROACHED ON THE BOARD'S DISCRETION, AND EXCEEDED THE PROPER STANDARD OF REVIEW.

The Berkeley Rent Stabilization Board is an administrative body directly elected by the people. Such bodies have considerable discretion. As the California Supreme Court stated in Carson Mobilehome Park Owners' Assn. v. City of Carson (1983) 35 Cal.3d 187, at p. 191: "Rent control agencies are not obliged by either the state or federal Constitution to fix rents by

application of any particular method or formula." (citations omitted). The Board in this instance has chosen the MNOI formula, which is not only rational, but in fact superior to other formulae. By prescribing a different formula for post 1979 purchasers, the Trial Court has infringed on the Board's discretion.

The proper standard of review of an action of an administrative body, whether under a Writ of Mandate or in a Declaratory relief action is to determine whether the action is rational under the law and the Constitution. The burden is on the challengers to prove that it is not. Judge Sutter is fully aware of this fact and repeatedly holds, in relation to other issues herein, as follows: "[the Board] was not obliged to adopt plaintiff's alternative, and it is not the court's role to compel a different result from that selected by the elected board." (Tentative Decision, p. 9, 6JA 104 at 2027) "While [the Board] might have reached a contrary conclusion, it was not compelled to adopt the opinions of plaintiffs' experts." (ibid.) "The Board might have selected some different standard, but it was not compelled to do so." (Tentative Decision. p. 20, 6JA 104 at 2038) The same reasoning applies to the Trial Judge's ruling concerning post 1979 purchasers.

VII. CONCLUSION.

These Amici Curiae submit that the ruling below concerning post 1979 purchasers should be reversed, that all the rest of the Trial Court Judgment should be affirmed, and that the challenged regulations should be upheld in their entirety.

DATED: April 15, 1993

Respectfully submitted,

Dagmar Searle

DAGMAR SEARLE
Amicus Curiae and attorney
for Searle Amici Curiae

LEVIN-ZIMEL, INC.,

Testimony,

NO. 1992-1

vs.

MOTION ON PETITION
FOR WRIT OF HABEAS

CITY OF BERKELEY, CITY
STABILIZATION BOARD, & DAVID
BERRY, and DOES 1 through 50,
Inclusive,

Respondents,

HERBERT ELDRIDGE, ARTHUR HARRIS,
COLLEEN HILLIGER, ANNETTE
RICHMOND, WILLIAM WY, JONATHAN
DOWMAN, GAIL FORD, JOHN HEAL,
MARTIN CASEY, RANDALL DOMITROV,
ALICE LUCAS, JANE BUSTON, ELISE
SOOKBERG, LEONARD LEVENTER,
JONATHAN LEWIS, JOHN FREASE,
BRUCE TSUKASAKI, ARTHUR HILL,
JOSEPHINE HILLON, KATHY CALDWELL,
NORA MARINO, BRUCE ANDERSON,
MIRIELLE GALE, JAMES HANSON, and
DOES 11 through 50, Inclusive.

Real Parties in Interest.

IN THE SUPERIOR COURT OF THE STATE OF CALIFORNIA

IN AND FOR THE COUNTY OF ALAMEDA

FILED
ALAMEDA COUNTY

MAR 20 1986

RENE C. DAVIDSON, County Clerk
By Shirley Stewart

LEVIN-ZEMEL, INC.,

Petitioner,

vs.

CITY OF BERKELEY RENT
STABILIZATION BOARD, a public
entity, and DOES 1 through 10,
inclusive,

Respondents,

HERBERT ELOESSER, ARTHUR RIGGS,
COLETTE JOLICOEUR, ANNETTE
RODRIGUEZ, WILLIAM NYE, JONATHAN
DOKFMAN, CARL POPPE, JOHN NEAL,
MARION CASEY, RANDALL RODRIGUEZ,
ALICE LUCAS, JANE BURTON, ELSIE
SODERBERG, LEONARD LEVENTER,
JOHNATHAN LEWIS, JOHN FREASE,
BRUCE TSUKASAKI, ARTHUR NIELD,
JOSEPHINE GORDON, KATHY CALDWELL,
NORA RAGGIO, GRACE ANGERMAN,
MIRIELLE GALE, JAMES HANSEN, and
DOES 11 through 50, inclusive,

Real Parties in Interest.

NO. 598234-3

RULING ON PETITION
FOR WRIT OF MANDATE

Exhibit A

Conclusion

Pursuant to Subd.(f) Section 1095.5 C.C.P. this matter is remanded to the Board for reconsideration of its decision in light of this opinion. Upon reconsideration the Board is directed: (1) to recalculate NOI so as to treat annual Rent Board fees as an expense item; (2) within 90 days of this decision to adopt regulations for IRA petitions in which the owner alleges that his base year rent was unreasonably low, which regulations will allow the owner a fair return on investment; (3) within 120 days of this decision to apply the regulations, as adopted, to Landlord, adjusting his rents accordingly; (4) to make any rent adjustment effective as of 182 days (120 days plus 62 days for continuances to which Landlord stipulated) from the date the application was filed, or otherwise to adjust rents so as to avoid penalizing Landlord for the Board's delay in processing this application; and (5) to redetermine the issue of laches and, if applicable, to modify the Board's prior order on overcharges.

The Board's decision of October 16, 1984 is vacated only to the extent that it is inconsistent with this opinion. Pending reconsideration by the Board, tenants are ordered to cease withholding rents pursuant to the October 16 Board decision, but this order does not bar the board from a new rent withhold order upon reconsideration.

Counsel for Petitioner is to prepare a Proposed Peremptory Writ of Mandate consistent with this decision, submitting it first to the City Attorney for review before submitting it to the court.

No provision of these regulations shall be applied so as to prohibit the granting of an individual fair adjustment that is demonstrated necessary by the landlord to provide the landlord with a fair return on investment.

Landlord is entitled to cost of suit. His request for attorney's fees

pursuant to Section 800 Government Code and Section 1021.5, C.C.P. is denied.

Dated: MAR 20 1986

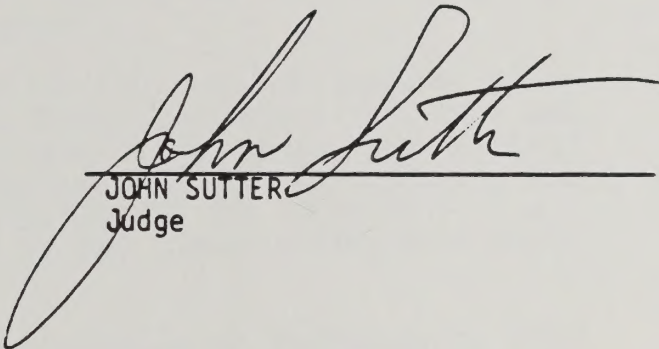

JOHN SUTTER
Judge

EXHIBIT B

Exhibit A p. 4

1275. Fair Return on Investment.

No provision of these regulations shall be applied so as to prohibit the granting of an individual rent adjustment that is demonstrated necessary by the landlord to provide the landlord with a fair return on investment.

Investment is defined as either equity or property value, as appropriate, pursuant to regulations of the Rent Stabilization Board. However, until such time as the Board adopts regulations setting forth specific guidelines to be used in determining the rent ceiling level for a unit(s) which would provide the landlord with a fair return on investment based on equity or property value, the rent ceiling level necessary to provide a fair return on investment shall be calculated according to Sections 1262-1274 of the Board's regulations.

Exhibit C

Exhibit B

1264. Maintenance of Net Operating Income (Fair Return)

(A) The landlord is entitled to a fair return. Ordinarily, a fair return will be measured by maintaining the net operating income produced by the property in the base year, adjusted by 100% of the percentage increase in the Consumer Price Index (CPI), All Urban Consumers, for the San Francisco-Oakland-San Jose metropolitan area, less its shelter component, as reported by the U.S. Bureau of Labor Statistics, since June 1979, if 1979 is the base year, or since June of any alternative base year. Rent ceilings shall be adjusted prospectively, subject to the limitations set forth in Section 1274, upon a showing that the net operating income in the comparison year is not equal to the base year net operating income adjusted by 100% of the percentage increase in the CPI since June 1979, if 1979 is the base year, or since June of any alternative base year.

(B) The percentage increase in the CPI shall be determined by comparing the monthly CPI for All Urban Consumers for the San Francisco-Oakland-San Jose metropolitan area, less its shelter component, as reported by the U.S. Bureau of Labor Statistics, for June of the comparison year to the monthly CPI for June 1979 (i.e., 73.2), or the monthly CPI for June of any alternative base year, whichever is later.

(C) Any individual adjustment established pursuant to this section shall take into account annual general adjustments for which the landlord is entitled up to and including the adjustment for the comparison year, and shall also take into account in the comparison year rent increases allowed under the 1991 Inflation Adjustment Order (Regulation 1113). The comparison year shall be the most recent calendar or fiscal year, unless another period is found by the hearing examiner to be more appropriate.

[Amended Regulation 1264 effective March 20, 1992]

Exhibit C

(b) The presumption specified in subdivision (a) does not arise unless all of the conditions set forth therein are proven, but failure to so establish the presumption shall not otherwise affect the right of the tenant to raise and pursue any defense based on the landlord's breach of the implied warranty of habitability.

(c) The presumption provided in this section shall apply only to rental agreements or leases entered into or renewed on or after January 1, 1986.

(Added by Stats.1985, c. 1279, p. —, § 1.)

§ 1942.4. Actual and special damages; landlord liability; conditions; attorney's fees; remedies; small claims court

(a) Any landlord who demands or collects rent when all of the following conditions exist is liable to the tenant or lessee for the actual damages sustained by the tenant or lessee and special damages in an amount not less than one hundred dollars (\$100) nor more than one thousand dollars (\$1,000):

(1) The rental dwelling substantially lacks any of the affirmative standard characteristics listed in Section 1941.1.

(2) A public officer or employee who is responsible for the enforcement of any housing law has notified the landlord, or an agent of the landlord, in a written notice issued after inspection of the premises which informs the landlord of his or her obligations to abate the nuisance or repair the substandard conditions.

(3) The conditions have existed and have not been abated 60 days beyond the date of issuance of the notice specified in paragraph (2) and the delay is without good cause.

(4) The conditions were not caused by an act or omission of the tenant or lessee in violation of Section 1929 or 1941.2.

(b) In addition to recovery of allowable costs of suit, the prevailing party shall be entitled to recovery of reasonable attorney's fees in an amount fixed by the court.

(c) The tenant or lessee shall be under no obligation to undertake any other remedy prior to exercising his or her rights under this section.

(d) Any action under this section may be maintained in small claims court if the actual or special damages claimed are within the jurisdictional amount specified in Section 116.2 of the Code of Civil Procedure.

(e) The remedy provided by this section applies only to rental agreements or leases entered into or renewed on or after January 1, 1986, and may be utilized in addition to any other remedy provided by this chapter, the rental agreement, lease, or other applicable statutory or common law.

(Added by Stats.1985, c. 1279, p. —, § 2.)

§ 1942.5. Retaliation; prohibited acts; violations; remedies; penalties

Cross References

Farm labor camps, enforcement of tenants' rights, see Health and Safety Code § 17031.5.

Labor camp eviction proceedings, defense of protected activity under this section, see Health and Safety Code § 17031.6.

Notes of Decisions

Burden of proof 8.5

Foreclosure 12

Good faith, acts of lessor 13

4. Common law retaliatory eviction defense

Statute which provides retaliatory eviction defense in actions between lessors and lessees provides remedies which are in addition to remedies provided by decisional common law and thus, statute does not limit defense to lessor-lessee

relationships. California Livestock Production Credit Ass'n v. Sutfin (App. 3 Dist.1985) 211 Cal.Rptr. 152, 165 C.A.3d 648.

8.5. Burden of proof

Tenants who asserted defense of retaliatory eviction in unlawful detainer action had burden of proving by preponderance of evidence that landlord evicted them in retaliation for their complaints to county health department and their filing of lawsuit against landlord. Western Land Office, Inc. v. Cervantes (App. 6 Dist.1985) 220 Cal.Rptr. 784.

12. Foreclosure

Where foreclosure was lawful and purchaser's title was lawfully perfected, and where mortgagors conceded that they were in default under deeds of trust, defense of retaliatory eviction, on theory that one mortgagor's criticism of mortgagee's management motivated eviction in violation of mortgagor's free speech rights, was unavailable to mortgagors in subsequent unlawful detainer proceedings. California Livestock Production Credit Ass'n v. Sutfin (App. 3 Dist.1985) 211 Cal.Rptr. 152, 165 C.A.3d 648.

13. Good faith—Acts of lessor

Proof of valid ground for landlord's action may undermine evidence of landlord's retaliatory motive, but proof of

valid ground is not equivalent to proof of good faith. Western Land Office, Inc. v. Cervantes (App. 6 Dist.1985) 220 Cal.Rptr. 784.

§ 1945. Renewal by continued possession and acceptance of rent

Notes of Decisions

Acceptance of rent 9

Corp. v. Wikman (App. 4 Dist.1986) 223 Cal.Rptr. 262, 178 C.A.3d 61.

9. Acceptance of rent

2. Tenant holding over after expiration of term—In general

Tenant's mere possession of property at termination of lease was sufficient to indicate its intention to extend lease term and, therefore, to exercise option to renew. ADV

Neither landlord's acceptance of full month's lease payment prior to expiration of lease on the 14th of the month nor retention of the full payment after expiration signified consent to tenant's continued possession to raise statutory presumption that lease continued under the same terms where retrospective annual adjustments remained to be made for certain utility and other payments. City v. Hart (App. 4 Dist.1985) 220 Cal.Rptr. 349, 175 C.A.3d 92.

§ 1946.5. Room by single lodger on periodic basis within dwelling unit occupied by owner; termination; written notice; removal from premises

(a) The hiring of a room by a lodger on a periodic basis within a dwelling unit occupied by the owner may be terminated by either party giving written notice to the other of his or her intention to terminate the hiring, at least as long before the expiration of the term of the hiring as specified in Section 1946. The notice shall be given in a manner prescribed in Section 1162 of the Code of Civil Procedure or by certified or registered mail, restricted delivery, to the other party, with a return receipt requested.

(b) Upon expiration of the notice period provided in the notice of termination given pursuant to subdivision (a), any right of the lodger to remain in the dwelling unit or any part thereof is terminated by operation of law. The lodger's removal from the premises may thereafter be effected pursuant to the provisions of Section 602.3 of the Penal Code or other applicable provisions of law.

(c) As used in this section, "lodger" means a person contracting with the owner of a dwelling unit for a room or room and board within the dwelling unit personally occupied by the owner, where the owner retains a right of access to all areas of the dwelling unit occupied by the lodger and has overall control of the dwelling unit.

(d) This section applies only to owner-occupied dwellings where a single lodger resides. Nothing in this section shall be construed to determine or affect in any way the rights of persons residing as lodgers in an owner-occupied dwelling where more than one lodger resides.

(Added by Stats.1986, c. 1010, § 1.)

§ 1947. Rent; time of payment

Notes of Decisions

6. Defenses

Fisher v. City of Berkeley (1984) 209 Cal.Rptr. 682, 693 P.2d 261, 37 C.3d 644 [main volume] appeal dismissed in

part, probable jurisdiction noted 105 S.Ct. 2653, 86 L.Ed.2d 270, affirmed 106 S.Ct. 1045, 89 L.Ed.2d 206, rehearing denied 106 S.Ct. 1806.

§ 1947.7. Legislative findings, declarations, and intent concerning standards of compliance with local rent stabilization programs; owners of residential rental units in substantial compliance with local rent controls; penalties and sanctions

(a) The Legislature finds and declares that the operation of local rent stabilization programs can be complex and that disputes often arise with regard to standards of compliance with the regulatory processes of those programs. Therefore, it is the intent of the Legislature to limit the imposition of penalties and sanctions against an owner of residential rental units where that person has attempted in good faith to fully comply with the regulatory processes.

(b) An owner of a residential rental unit who is in substantial compliance with an ordinance or charter that controls or establishes a system of controls on the price at which residential rental units may be offered for rent or lease and which requires the registration of rents, or any regulation

adopted pursuant thereto, shall not be assessed a penalty or any other sanction for noncompliance with the ordinance, charter, or regulation.

Restitution to the tenant or recovery of the registration or filing fees due to the local agency shall be the exclusive remedies which may be imposed against an owner of a residential rental unit who is in substantial compliance with the ordinance, charter, or regulation.

"Substantial compliance," as used in this subdivision, means that the owner of a residential rental unit has made a good faith attempt to comply with the ordinance, charter, or regulation sufficient to reasonably carry out the intent and purpose of the ordinance, charter, or regulation, but is not in full compliance, and has, after receiving notice of a deficiency from the local agency, cured the defect in a timely manner, as reasonably determined by the local agency.

"Local agency," as used in this subdivision, means the public entity responsible for the implementation of the ordinance, charter, or regulation.

(c) Nothing in this section shall be construed to grant to any public entity any power which it does not possess independent of this section to control or establish a system of control on the price at which accommodations may be offered for rent or lease, or to diminish any such power which that public entity may possess, except as specifically provided in this section.

(Added by Stats.1986, c. 1199, § 1.)

§ 1947.8. Local rent controls; establishment and certification of permissible rent levels; appeal; fee; public record

(a) If an ordinance or charter controls or establishes a system of controls on the price at which residential rental units may be offered for rent or lease and requires the registration of rents, the ordinance or charter, or any regulation adopted pursuant thereto, shall provide for the establishment and certification of permissible rent levels for the registered rental units, and any changes thereafter to those rent levels, by the local agency as provided in this section.

(b) If the ordinance, charter, or regulation is in effect on January 1, 1987, the ordinance, charter, or regulation shall provide for the establishment and certification of permissible rent levels on or before January 1, 1988, including completion of all appeals and administrative proceedings connected therewith. If the ordinance, charter, or regulation is adopted on or after January 1, 1987, the ordinance, charter, or regulation shall provide for the establishment and certification of permissible rent levels within one year after it is adopted, including completion of all appeals and administrative proceedings connected therewith. Upon the request of the landlord or the tenant, the local agency shall provide the landlord and the tenant with a certificate or other documentation reflecting the permissible rent levels of the rental unit. The landlord or the tenant may appeal the determination of the permissible rent levels reflected in the certificate. The permissible rent levels reflected in the certificate or other documentation shall, in the absence of misrepresentation or fraud, be binding and conclusive upon the local agency unless the determination of the permissible rent levels is being appealed.

(c) After the establishment and certification of permissible rent levels under subdivision (b), the local agency shall, upon the request of the landlord or the tenant, provide the landlord and the tenant with a certificate of the permissible rent levels of the rental unit. The certificate shall be issued within five business days from the date of request by the landlord or the tenant. The permissible rent levels reflected in the certificate shall, in the absence of misrepresentation or fraud, be binding and conclusive upon the local agency unless the determination of the permissible rent levels is being appealed. The landlord or the tenant may appeal the determination of the permissible rent levels reflected in the certificate. Any appeal of a determination of permissible rent levels as reflected in the certificate, other than an appeal made pursuant to subdivision (b), shall be filed with the local agency within 15 days from issuance of the certificate. The local agency shall notify, in writing, the landlord and the tenant of its decision within 60 days following the filing of the appeal.

(d) The local agency may charge the person to whom a certificate is issued a fee in the amount necessary to cover the reasonable costs incurred by the local agency in issuing the certificate.

(e) The absence of a certification of permissible rent levels shall not impair, restrict, abridge, or otherwise interfere with either of the following:

(1) A judicial or administrative hearing.

(2) Any matter in connection with a conveyance of an interest in property.

(f) The record of permissible rent levels is a public record for purposes of the California Public Records Act, Chapter 3.5 (commencing with Section 6250) of Division 7 of Title 1 of the Government Code.

(g) Any notice specifying the rents applicable to residential rental units which is given by an owner to a public entity or tenant in order to comply with Chapter 12.75 (commencing with Section 7060) of Division 7 of Title 1 of the Government Code shall not be considered a registration of rents for purposes of this section.

(h) "Local agency," as used in this section, means the public entity responsible for the implementation of the ordinance, charter, or regulation.

(i) Nothing in this section shall be construed to grant to any public entity any power which it does not possess independent of this section to control or establish a system of control on the price at which accommodations may be offered for rent or lease, or to diminish any such power which that public entity may possess, except as specifically provided in this section.

(Added by Stats.1986, c. 1199, § 2.)

§ 1950.5. Security for rental agreement for dwelling property of tenant; "security" defined; limits on amount; mutual agreements; priority; claims against security; itemized statement and accounting; landlord's successors in interest; itemized statement of deductions from security; damages; actions in small claims court; evidence

(a) The provisions of this section shall apply to security for a rental agreement for residential property, that is, property used as the dwelling of the tenant.

(b) As used in this section, "security" means any payment, fee, deposit or charge, including, but not limited to, an advance payment of rent, used or to be used for any purpose, including, but not limited to, any of the following:

(1) The compensation of a landlord for a tenant's default in the payment of rent.

(2) The repair of damages to the premises, exclusive of ordinary wear and tear, caused by the tenant or by a guest or licensee of the tenant.

(3) The cleaning of the premises upon termination of the tenancy.

(4) To remedy future defaults by the tenant in any obligation under the rental agreement to restore, replace or return personal property or appurtenances, exclusive of ordinary wear and tear, if the security deposit is authorized to be applied thereto by the rental agreement.

(c) A landlord may not demand or receive security, however denominated, in an amount or value in excess of an amount equal to two months' rent, in the case of unfurnished residential property, and an amount equal to three months' rent in the case of furnished residential property, in addition to any rent for the first month paid on or before initial occupancy.

This subdivision does not prohibit an advance payment of not less than six months' rent where the term of the lease is six months or longer.

This subdivision does not preclude a landlord and a tenant from entering into a mutual agreement for the landlord, at the request of the tenant and for a specified fee or charge, to make structural, decorative, furnishing, or other similar alterations, if the alterations are other than cleaning or repairing for which the landlord may charge the previous tenant as provided by subdivision (e).

(d) Any security shall be held by the landlord for the tenant who is party to the lease or agreement. The claim of a tenant to the security shall be prior to the claim of any creditor of the landlord.

(e) The landlord may claim of the security only those amounts as are reasonably necessary for the purposes specified in subdivision (b). The landlord may not assert a claim against the tenant or the security for damages to the premises or any defective conditions that preexisted the tenancy, for ordinary wear and tear or the effects thereof, whether the wear and tear preexisted the tenancy or occurred during the tenancy, or for the cumulative effects of ordinary wear and tear occurring during any one or more tenancies.

(f) Within two weeks after the tenant has vacated the premises, the landlord shall furnish the tenant, by personal delivery or by first-class mail, postage prepaid, a copy of an itemized statement indicating the basis for, and the amount of, any security received and the disposition of the security and shall return any remaining portion of the security to the tenant.

1278. Petition to Obtain Previously Lost Annual General Adjustments (AGA's) Pursuant to CA Civil Code Section 1947.7

(A) General. When an owner who has previously been out of compliance comes into compliance with the ordinance, regulations, or applicable housing, health and safety codes, all AGA's lost during the period of noncompliance may be granted prospectively. For any residential unit which has been registered and for which a base rent has been listed or for any residential unit which an owner can show, by a preponderance of the evidence, a good faith attempt to comply with the registration requirements or who was exempt from registration requirements in a previous version of the ordinance and for which the owner of that residential unit has subsequently found not to have been in compliance with the ordinance or regulation, all annual rent adjustments which may have been denied during the period of the owner's non-compliance shall be restored prospectively once the owner is in compliance with the ordinance or regulation.

In addition, to be eligible, the owner must state under penalty of perjury that the unit is in substantial compliance with the ordinance, regulations and applicable codes. Specifically, he or she certify payment of all fees and penalties owed to the Rent Stabilization Program (RSP) which have not otherwise been barred by the statute of limitations, substantial compliance with applicable local and state housing code provisions, and satisfaction of all claims for refunds of rental overcharges brought by tenants or by the RSP on behalf of tenants of the affected unit.

The owner is not entitled to recover any AGA's which have been previously regained through a net operating income analysis.

(B) Petition. Upon the petition of the landlord, the owner's eligibility for previously lost AGA's shall be determined. There is no filing fee.

At the time of filing the petition, the owner shall submit a proof of service showing that all opposing parties have been provided with a complete copy of the documents filed.

Sections 1201-1213 of these regulations shall govern all additional petition procedures for AGA petitions.

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Exhibit E

1278. Petition to Obtain Previously Lost Annual General Adjustments (AGA's Pursuant to CA. Civil Code Section 1947.7 - Page 2.

(C) Administrative Determination. The petition may be decided without a hearing where no material facts are in dispute, all needed information is filed with the petition, and the owner waives his/her right to a hearing in any of the following circumstances:

(1) The owner submits an agreement with the petition which is signed by the parties in accordance with Section 1232 of these Regulations.

(2) The unit(s) included in the petition are vacant.

(3) The tenant(s) fails to file a response to the petition within thirty-five (35) days of the date the response form is mailed to the tenant(s).

(D) Hearing Procedure. The procedure governing hearings and appeals in individual rent adjustment petitions set forth in Sections 1221-1259 of these regulations shall apply to petitions to obtain previously lost AGA's. The following additional procedures shall also apply:

(1) If the increase requested exceeds 20% of the current rent and the tenant shows by a preponderance of the evidence it would cause undue financial hardship if taken at once, the Hearing Examiner shall grant a phased-in rent increase for the amount over 20%, in equal installments for a period up to three years.

(2) If the tenant establishes that the owner has not refunded rent overcharges for the unit, or that the building is not in substantial compliance with registration requirements, that the affected unit is not in substantial compliance with housing, health and safety codes, these issues shall be fully adjudicated in the course of the hearing on the petition to obtain previously lost AGA's and the Hearing Examiner shall make the appropriate order pursuant to Chapter 12 of these regulations.

(3) The decision will be issued within sixty (60) days of hearing, unless the time is extended for good cause at the owner's request.

[Regulation 1278 effective January 12, 1990.]

10/92

Exhibit Ep2

1278.5 Petition to Obtain Annual General Adjustments (AGA's)
Lost Due to a Good Faith Failure to Register.

(A) The lawful rent ceiling of a rental unit shall be adjusted prospectively by all Annual General Adjustments for which a petitioner is otherwise ineligible due to the owner's failure to register the rental unit, if:

(1) the rental unit is currently properly registered;

(2) the prior failure to register the rental unit is demonstrated by a preponderance of the evidence to have been the result of a good faith error; and

(3) the petitioner demonstrates or certifies under penalty of perjury that the unit is in substantial compliance with all provisions of the Rent Stabilization Ordinance, Regulations, orders of the Board and applicable housing and safety codes.

(B) The owner is not entitled to recover any AGA's which have been previously regained through a net operating income analysis.

(C) The provisions of subsections (B), (C) and (D) of Regulation 1278 shall apply to petitions brought under this regulation.

[Effective October 23, 1992]

Exhibit F

10/92

PROOF OF SERVICE

I, DAGMAR SEARLE, declare. I am a prospective Amicus Curiae in propria persona in this matter and attorney for SEARLE Amici Curiae. On April 16, 1993 I caused the Brief Amicus Curiae of Dagmar Searle and John R. Searle to be served by placing a true copy thereof, enclosed in a sealed envelope, with first class postage fully prepaid, in the United States mail at Berkeley California, addressed as set forth below:

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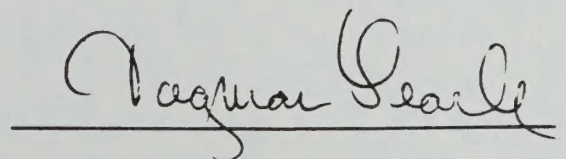
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I declare under penalty of perjury that the foregoing is true and correct and that this declaration was executed on April 16, 1993 at Berkeley, California.



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